Building a Case for Zero Revenue Share

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04.15.2016

The traditional use of revenue share to pay for recordkeeping services has become a popular topic given increased regulatory and litigation concerns. This paper addresses the issues surrounding revenue share, including its lack of transparency, fee disparity between participants, and potential conflicts in fund selection.

What is Revenue Share?

A mutual fund's expense ratio comprises various fees that pay for fund expenses, including investment management, administrative costs, and marketing and distribution fees. Revenue share typically consists of the latter and includes publicly disclosed 12(b)-1 fees and non-disclosed sub-transfer agent ("Sub-TA") fees.

The 12(b)-1 fee gets its name from a section in the Investment Company Act of 1940 that allowed new mutual funds to pay advertising and marketing expenses associated with establishing the funds in the marketplace. Today, the 12(b)-1 fee has been repurposed to defray the cost of recordkeeping. It is disclosed in the fund's prospectus, but not on a participant's statement. While participants are able to find the 12(b)-1 fee if they know where to look in a fund's prospectus, it does not define how the revenue generated from the fee is used in their plan. The Sub-TA fee is not disclosed in the prospectus and is used to pay a transfer agent for the execution, clearing, and settlement of orders for shares of a mutual fund, much of which has been automated through the evolution of technology.

Example 1

Anatomy of an Expense Ratio	
Investment Management	50 bps
Administration & Legal	15 bps
12(b)-1 Fee (marketing)	25 bps
Sub-Transfer Agency	10 bps
Expense Ratio	100 bps

The amount of revenue share that each fund generates varies among funds, share classes, and even recordkeepers. For example, there may be an additional 10 bps in revenue share provided to Recordkeeper A but not to Recordkeeper B. Also, certain recordkeepers who also manage mutual funds may only provide revenue share to their own recordkeeping clients, not to third parties. So, while they may be open architecture by design, there is a clear financial incentive to use proprietary products.

Regulatory and Litigation Considerations

Defined Contribution plan sponsors continue to come under scrutiny for plan fees. Going back a decade, more than a dozen class action lawsuits have been filed. In recent months, we've seen the frequency of suits accelerate. Since November 2015, at least five lawsuits against employers over alleged breaches of fiduciary duty related to excessive fees have been filed or settled. Much of the litigation was a result of the plan sponsor's failure to monitor and document recordkeeper and investment management fees. Of these cases that have been resolved, defendants settle with no admission of guilt or wrongdoing. Since most of these cases have not been adjudicated, a legal precedent has not been established that would help sponsors determine which practices are defensible and which are not.

While the use of revenue share has not been explicitly prohibited by regulators, we think sponsors who utilize the practice should thoroughly document their rationale and demonstrate an accounting of all revenue received and used to offset plan expenses. For sponsors who have this flexibility, Summit believes the use of a zero revenue share fee model minimizes legal and regulatory exposure.

Transparency

One of the inherent problems with revenue share is its lack of transparency. Prior to the passage of ERISA Section 408(b)(2), it was very difficult for plan sponsors to account for all revenue share and determine the true cost of services rendered. Under ERISA, each plan sponsor must receive a declaration of revenue received in support of that relationship, including all forms of revenue share. While this has increased the transparency for plan sponsors, participants still do not have a simple and reliable means to determine the amount of revenue share included in each option offered by the plan.

This lack of disclosure at the participant level results in mutual funds looking more expensive than they really are, resulting in an apples to oranges comparison of costs. For example, working spouses may compare the options available under their separate employer's plan. The husband's plan offers an S&P 500 Index fund for 5 bps and charges every participant a separate annual $50 recordkeeping fee, while the wife's plan offers a similar S&P 500 Index fund for 20 bps with no recordkeeping fee.

The wife may immediately conclude that her plan's S&P 500 Index fund is overpriced relative to her husband's. However, the expense ratio for her fund may include 15 bps of revenue share used to offset recordkeeping costs. In this scenario, the "net cost" of asset management for both funds is the same 5 bps. Yet, because each plan has chosen a different manner in which to pay for recordkeeping services, the wife's plan appears to be more expensive, when it may not since there are no other account fees. The key takeaway in this example is that *how* you pay for recordkeeping services is just as important as *what* you pay. All else being equal, the use of revenue share can lead to the misperception a plan is too expensive.

Inequity

Another drawback of revenue share is the inequitable manner in which it is collected. As noted earlier, the amount of revenue share varies by fund. It is rare that every option in the plan has the same level of revenue share. The table at right illustrates this concept.

Example 2

	Investment Management	Revenue Share	Expense Ratio
Passive Fund	5 bps	0 bps	5 bps
Active Fund	50 bps	25 bps	75 bps

In this example, two participants with the same $500,000 balance can pay very different fees for recordkeeping. In the absence of a separate account charge, a participant fully invested in the Passive Fund will not pay any revenue share or recordkeeping fees, while a participant fully invested in the Active Fund will pay $1,250 (25bps rev share x $500k) annually for the exact same services available to the passive investor. The revenue share disparity is not limited to just active or passive funds, but extends to all options within the menu.

Participants should pay the exact same amount for recordkeeping services regardless of how they invest. To accomplish this goal many sponsors have changed the fee structure of their recordkeeping contracts from an asset-based fee (e.g., 25 bps in weighted total plan revenue share) to a fixed per-participant charge (e.g., $50 per head). While a per-participant fee may be expensive for those with smaller balances, it is the most equitable option and will represent a smaller percentage of account assets as they grow over time.

Impact on Investment Selection

Avoiding a revenue share fee model also helps mitigate conflicts during the fund selection process. If a plan that uses revenue share were to conduct a fund replacement search it would likely search for funds that share an equivalent amount of revenue, therefore eliminating attractive non-revenue sharing funds from contention and further narrowing the universe of possible options.

Sponsors that utilize a zero revenue share model can select any fund or share class for which the plan qualifies. Should a fund have revenue share, it can be rebated back to the participant who paid it. Zero revenue share fee models also allow the sponsor to consider using commingled trusts and separate accounts, which typically do not provide revenue share, further expanding the universe of lower-cost options.

Conclusions

Revenue share has been repurposed over the last several decades to help plan sponsors finance the cost of recordkeeping services. This practice has come under scrutiny from litigators and regulators, strongly encouraging plan sponsors to consider alternative ways to pay for recordkeeping services. In the absence of any clear legal precedent or specific guidance from the DoL, many Summit clients have been proactive in abandoning the use of revenue share and implementing a consistent per-participant charge directly applied to each participants' balance. This solution eliminates potential conflicts of interest in fund selection associated with the use of revenue share and is a far more transparent and equitable fee structure.

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