Conducting a Successful Fee Review

How to determine whether plan fees are reasonable.

By Donald Stone

Conducting a fee review is difficult and can be a frustrating, time-consuming job for plan sponsors. Often plan sponsors aren't sure what to ask and, if they get the information, how to evaluate it. Yet ERISA makes it clear that plan fiduciaries have a duty to determine whether plan fees are reasonable. And the Employee Benefits Security Administration (EBSA) says that service providers must provide full disclosure of fees paid, commissions earned (direct and indirect), and any revenue sharing arrangements (Advisory Opinion 2005-02).

Plans at the highest risk for unreasonable fees, and therefore should conduct a comprehensive and documented review, are those that:

- Have average participant balances of more than $25,000
- Haven't conducted a fee review in more than three years
- Don't know the compensation being paid to a financial advisor that is associated with the plan
- Don't know all of the share classes of funds that may be available to the plan
- Contain a high proportion of proprietary funds
- Have a "zero" recordkeeping fee

Here are *six things plan fiduciaries need to ask* to determine if their plan's fees are reasonable and *where to find the answers.*

What Are You Currently Paying?

Where to find it: Billed fees should be in the service agreement or contract with the vendor. The same applies to asset-based fees. Fund expenses can be found in the prospectus for the fund or fact sheet for annuities. Transaction fees can be determined from the Statement of Additional Information filed with the SEC.

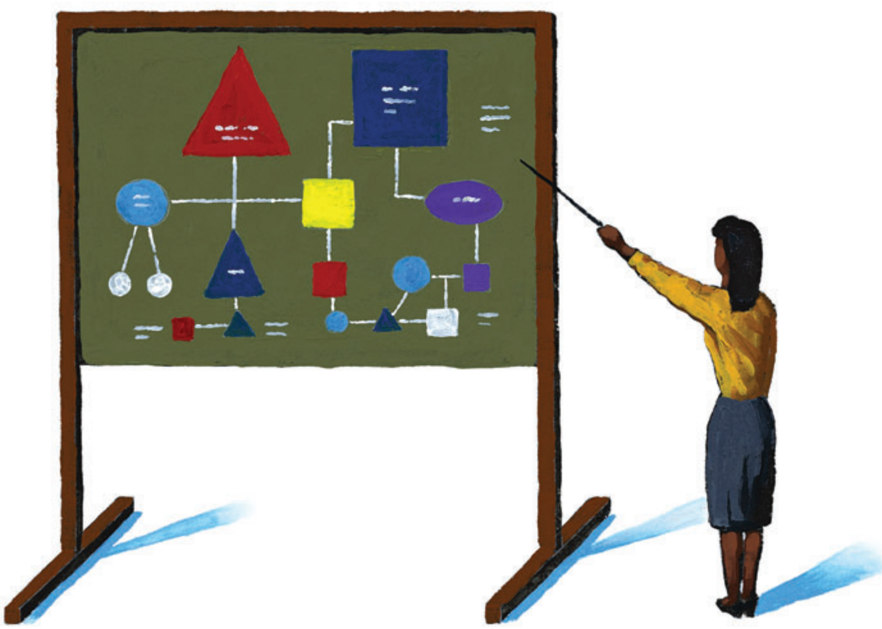
You can break what you are paying into four distinct parts.

Billed fees. These are usually straightforward and should be spelled out in the service agreement you have with your vendor. These include record keeping fees, base fees, compliance and testing fees, Form 5500 preparation fees, and fees for services outside the scope of agreed upon services. Today, many plans have "zero billed fees," meaning the vendor is earning revenue through asset-based or investment fees, and they are earning so much this way that they don't have to actually bill for the services they provide. While many plan sponsors like this (who likes to get a bill?), it is a tip-off that your plan expenses may be too high. The absence of billed fees results in participants paying a variable fee for services with a fixed cost. In any event, when they are rolled up into other areas rather than clearly spelled out, plan fiduciaries have difficulty determining what the plan services really cost.

Asset-based fees (also called wrap fees). Asset-based fees are typically charged by insurance companies on smaller plans (less than $5 million). But this type of fee (a percentage of assets) may be found on large plans that use vendors other than insurance companies when a fund doesn't pay revenue sharing to the recordkeeper (see below). In this instance they may be called "synthetic wrap fees" because the plan sponsor has chosen to impose them on the plan as a way to reduce or eliminate billed fees. Also vendors sometimes add an asset-based fee that looks like a fund expense ratio. For example, a vendor may create a commingled S&P 500 Index Fund that in reality is simply a low-cost mutual fund that has been wrapped with an additional fee.

Fund expense ratios. Plans that use mutual funds simply need the ticker symbol to look up the expense. Going by the name alone can be misleading, as the same fund name may have multiple share classes, each with a different expense ratio for the same underlying fund. Plans using annuities will have to rely on the vendor to provide the expense ratio of the fund and can usually, but not always, get a fact sheet on each fund from the vendor's Web site. Be aware that annuity products also have multiple expense ratios available for the same underlying fund, though this is often not well disclosed.

- So-called lifestyle funds should be reviewed carefully as they are usually "fund of funds," composed of varying proportions of other mutual funds or annuities. Fiduciaries should look for the weighted average expense of the underlying funds, but also check to see whether the fund has additional expense at the fund of funds level for managing the asset allocation.
- Stable value funds can represent a challenge for fiduciaries trying to understand expense. The vendor should be able to tell you what the management fee is for the fund being used by the plan (six different ones is not uncommon). Large plans should negotiate a management fee that makes sense rather than use one of the pre-determined price points. Because these are usually not registered funds, the vendor can set the management fee as they wish. If the vendor invests the plan's money in a pool of general assets of the vendor determining the management fee is more difficult. Generally vendors will not disclose what the pool is earning (the pool can be segmented into multiple sub-pools as well). In this instance a fiduciary will need to compare the rate offered with rates for other stable value products to determine indirectly whether the expense is reasonable. The fiduciaries should also satisfy themselves that they are comfortable with plan money being part of the general assets of the vendor.



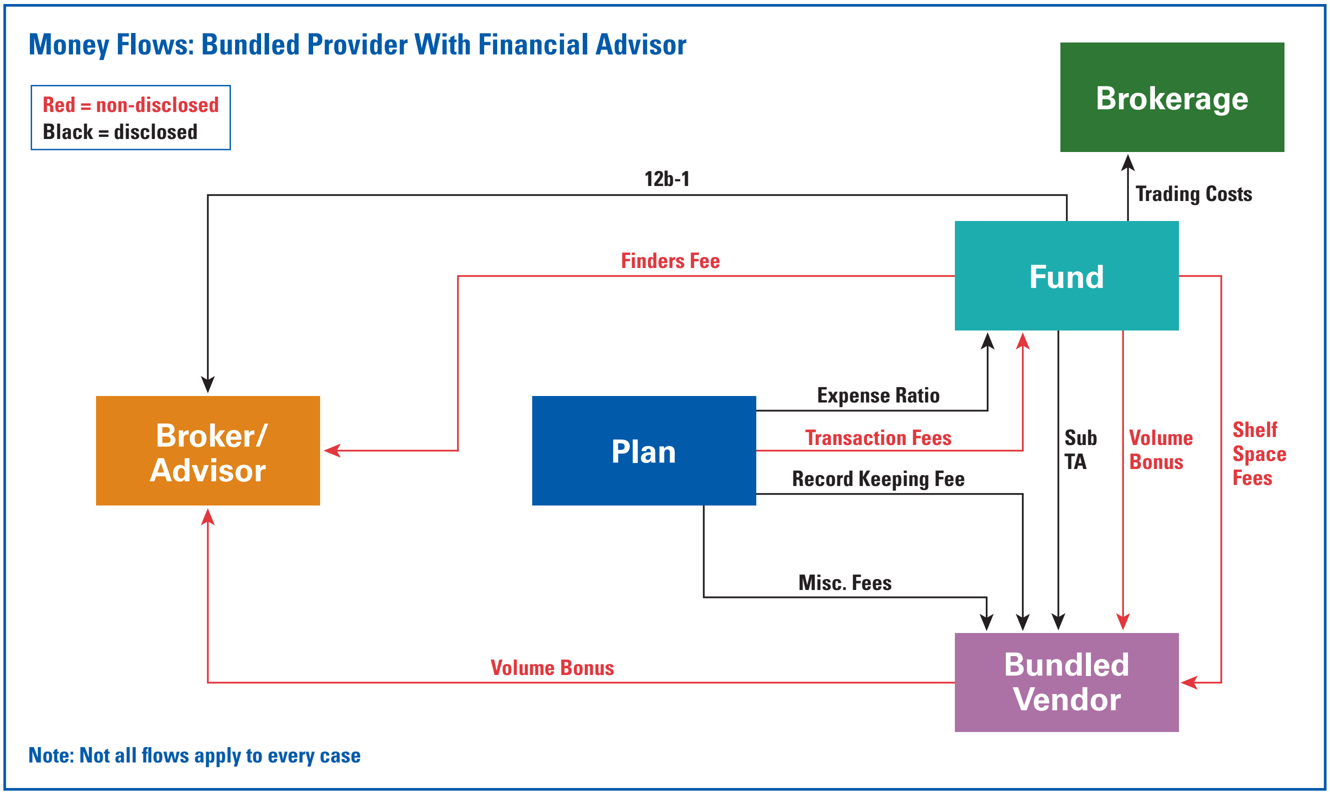
Transaction costs. Transaction costs for a fund are not disclosed. A document called the Statement of Additional Information that is filed with the SEC and can run hundreds of pages (annuity products have a similar document) will contain information about transaction costs. These costs have a significant impact on fund returns. Studies show that funds with high transaction costs generally perform poorly relative to funds with lower transaction costs over time. Plan fiduciaries can focus on the turnover in the fund as a proxy for high or low costs.

What Is the Vendor Earning?

Where to find it: Fees on proprietary funds and fee splits with sub-advisors are in the prospectus or fund fact sheet for annuities and the Statement of Additional Information. The vendor can provide its revenue sharing for each fund they offer, but it should also provide non-fund specific revenue sharing as well, such as marketing allowances, finder's fees, and distribution bonuses.

Proprietary Funds. There is a reason a vendor wants the plan to use proprietary funds: they generally make significantly more money on their own funds rather than someone else's. The same applies to sub-advised funds where the vendor hires an outside management firm to manage a fund. Finding out the revenue split between the vendor and the sub-manager can be difficult but not impossible. The vendor takes the lion's share of the revenue generated by this type of fund, not the actual fund manager.

Revenue Sharing. Typically the largest portion of a vendor's revenue is revenue sharing. Revenue sharing is the portion of a fund's expense that is used to subsidize the recordkeeper's services (and what may give you a "zero" recordkeeping fee). Revenue sharing takes many forms. The most common are: 12(b) 1 fees (a marketing fee that is part of many mutual funds' expense ratios and may also be used to pay a financial advisor) and sub-transfer agent, or sub-TA fees, that are part of the "other" category of mutual fund expense and can vary from vendor to vendor, even for the same fund. These may also be called shareholder servicing fees. In addition, the vendor may receive other compensation by charging for "shelf space" (to be on the vendor's investment menu), marketing allowances that pay for training, conferences, etc., finder's fees, and asset-based bonuses.



What Other Share Classes Are Available On the Vendor's Platform?

Where to find it: Ask the vendor to provide this information.

Vendors, and often financial advisors who get paid by the vendor, may direct plan fiduciaries toward share classes that pay more revenue sharing. This allows the zero-fee scenario and gives the vendor upside revenue based on asset growth regardless of the type of work being done. Often there is a lower expense version of the same fund and, even with an added recordkeeping fee, this will typically be the less expensive way to go. Mutual funds often have as many as five different share classes for the same underlying fund. Annuity products work the same way. You will need to find out which share classes are being used by your plan and whether there are cheaper ones available to you.

What Is the Price of Services For Your Plan In Today's Market?

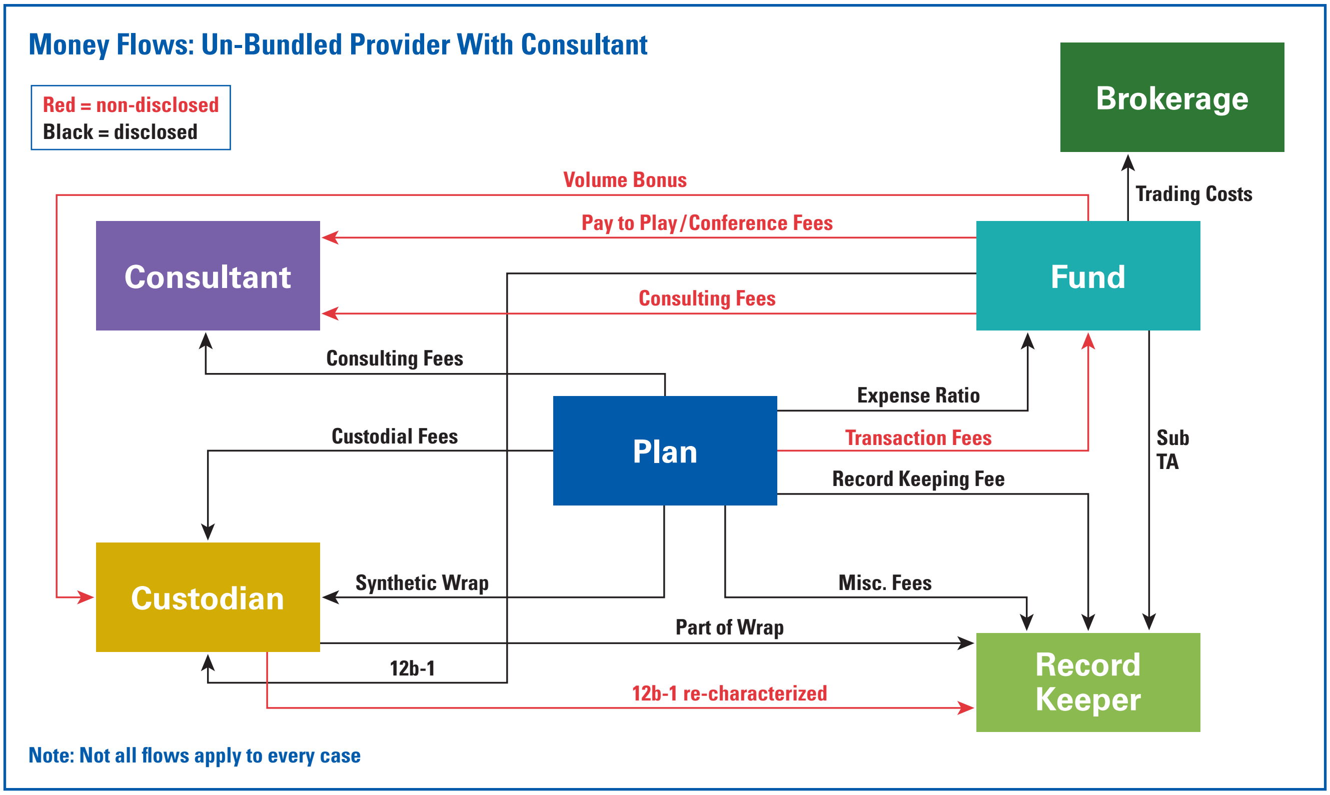
Where to find it: A full-blown search or, as an alternative, a blind search of similar vendors will provide this information.

This is the most reliable way of determining whether the fees the plan is paying are reasonable. This information can be obtained by putting your plan out to bid. Many plan sponsors are understandably reluctant to do this, as a search can be very time consuming. However, it will give your vendor a wake-up call that often results in lower fees. An alternative that can accomplish the same purpose without the major time commitment of a search is to have a consultant conduct a "blind search" where your plan's demographics and financial information are shopped discreetly to vendors and bids obtained. Armed with the results of this process you may be gratified to learn that your plan is reasonably priced, or you will have the data needed to have a serious discussion with your vendor.

What Is Your Advisor's Compensation?

Where to find it: Ask the advisor for written documentation. As an alternative you can ask the vendor.

If you use a financial advisor, do you know how much they are being compensated (the broker-dealer, not just the individual broker)? Financial advisor compensation can have a dramatic impact on total expenses of the plan, as it is built into your plan's expenses. If the compensation is reasonable for the services received, you can document it for the file. If not, you can negotiate with the advisor for a more reasonable fee or remove the advisor. This should be a three-way conversation with the vendor included so that every dollar that the advisor's fee is reduced comes back to the plan, not the vendor.



What Does It Cost the Vendor To Deliver the Services You Receive?

Where to find it: Vendors will not typically disclose this information to a client, although some consultants have a cost database.

The cost to deliver services has many variables, including whether the vendor is efficient in running their business and the total size of their book of business. It also varies based on the number of participants in your plan and the complexity of the administration of your plan. Most vendors build a budget for each plan they administer based on assumptions about calls to the call center, number of education meetings, hours of a relationship manager's time, etc. Top vendors are able to administer their overall book of business and earn their profit margin for less than $80 per participant (not including investment expense). Small plans should assume that it costs between $100-150 per participant, while plans with more than 4,000 participants can assume that the vendor makes money earning $50-60.

Negotiation Strategies

If you determine that the fees paid by your plan are high, there are a number of strategies you can pursue to get to an appropriate fee and to try and ensure that fees remain reasonable. Here are some to consider:

- A cap on total fees with any amount over the cap returning to the plan
- A cap on revenue sharing
- Have all revenue sharing go to the plan (not the vendor or broker) to be used to pay legitimate expenses of the plan as the fiduciaries determine
- Change investment choices to a lower-priced share class
- Ask the vendor to provide a budget for items such as education and have it returned to the plan if not used
- Negotiate out services you don't use
- Negotiate a lower fee for the broker or remove the broker if no value is being added
- Ask for a recordkeeping-only fee

Conducting a fee review requires time, patience, knowledge of industry practices, and good information about similar plans. Hiring a consultant that has experience in this area can save not only time, but may result in greater savings than you can achieve on your own. At the same time, not every plan is paying too much, but by conducting a fee review periodically you will demonstrate good fiduciary process and, if you are paying too much, a thorough, documented analysis of each step above will help you build a case for lower fees with your vendor.

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