For A Few Dollars More:
The Hidden Cost of 401(k) Revenue Sharing

By Ary Rosenbaum, Esq.

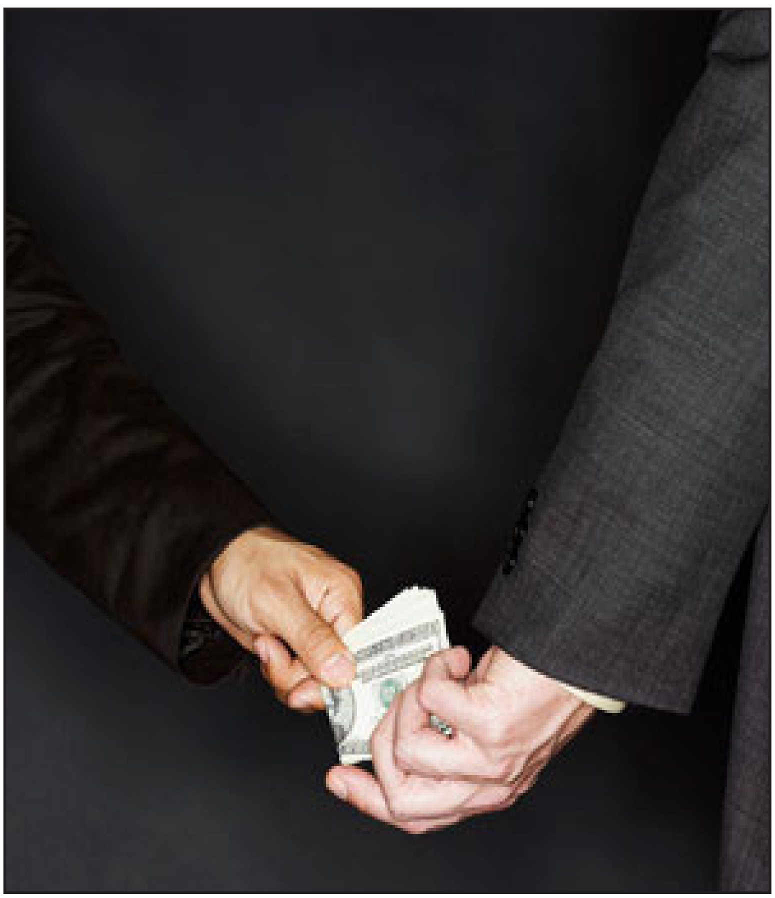
We have seen it all before. Whether it's greasing the palm of the maitre'd to get a table where you don't have a reservation or spotting the usher an extra $20 to get a better seat at the ballgame, we know how a few dollars more has the magic of changing minds.

Payola, is the illegal practice of payment by record companies for the broadcast of recordings on music radio, in which the song is presented as being part of the normal day's broadcast. A kickback is a return of a part of a sum received often because of confidential agreement or coercion.

In the 401(k) industry, revenue sharing is a compensation practice in which money is paid to plan providers out of 401(k) investments by the managers of these investments. Revenue sharing may also include 12b1 fees and sub t/a fees. Many fund companies pay revenue sharing fees in a variety of amounts and many mutual fund companies don't pay them. Many third party administration (TPA) firms and plan advisors herald the use of revenue sharing producing funds because these payments are supposed to be used to offset administrative expenses, which are usually borne by the plan participants.

Prior to the implementation of the fee disclosure regulations in January 2012, it is still possible that TPAs and plan advisors may not inform plan sponsors in the amount of the revenue sharing amounts received and what they are used for. I used to work for a TPA that actually pocketed the revenue sharing fees without disclosure and then invented a fee to justify the pocketing of those fees.

So if you look at the definition of payola and kickback, are revenue sharing payments that much different? Revenue sharing payments are an incentive for TPAs and plan advisors to steer 401(k) money to the funds that pay them because they are used to offset administrative expenses. Since some fund families pay them and some don't and some pay more than others, how is it not a kickback or like payola? The only reason I find is that the Department of Labor and Congress hasn't found the practice to be illegal.



Friends that I have in the industry say that I'm too hard on the revenue sharing practice and that I should keep in mind that this practice saves participants money because they typically are the ones who pay for the administration of their 401(k) plans. Without revenue sharing, my friends state that plan participants would lose more of their account balance to fees.

The problem with that argument is that there is a hidden cost with the selection of revenue sharing producing funds which negates their savings. The hidden cost is the actual selection of these revenue sharing producing funds. Since these funds pay revenue sharing to plan providers, they certainly have to be recouped in some fashion. Revenue sharing payments are not "manna from heaven", they are probably reflected in the fund's management expense ratio. Low cost mutual funds, index mutual funds, and exchange traded funds (ETFs) typically don't pay revenue sharing because of the low fee and transparency of these investments. It's hard for an index fund or ETF to pay 15 to 25 basis points to the TPA where their transparent managements fee could be even less than revenue sharing, Add in the fact that more than 70% of mutual funds fail to meet the benchmarks that index funds and ETFs almost meet, and then you see where I'm going. Revenue sharing payments may actually induce TPAs, plan advisors, and plan sponsors to pick funds that are more expensive and underperforming to funds that don't pay them. That would negate the benefits of these payments. So the hidden cost may be the lost opportunity to invest in a low fee funds that may produce a greater return that would more than compensate for the extra plan fees (since these funds pay no revenue sharing fees).

Here is another hidden cost, increased liability. A TPA I know states their fee and then states that their fee is lowered by the selection of "select" funds, as selected by the plan custodian. The selection of mutual funds for a participant directed ERISA §404(c) should be done in conjunction with the plan's investment policy statement (IPS). Does an investment policy statement state that whether a mutual fund pays revenue sharing is a part of the criteria for its selection? I don't recall seeing revenue sharing mentioned in an IPS. Is my legal theory that farfetched? Maybe, but probably would survive a motion for summary judgment.

As I have stated before in the past, plan sponsors must know the true cost of administration and that also includes any form of revenue sharing payments received by the TPA. If plan sponsors and trustees are unaware of the costs of administration and whether those fees are reasonable, they may be considered breaching their duty of prudence. If the TPA is less than forthcoming with these amounts, it may be almost impossible to find out as many plan custodians will claim that they are unaware of the arrangements between the fund companies and the TPAs. This is a problem since the plan sponsor and the trustees have a fiduciary duty to know the costs of plan administration. I know of a financial advisor who feels he may have recently solved a very large mystery as to what has been happening to the 12b1 fees of the funds that his clients have been receiving and these amounts have not been used to offset plan expenses. Needless, to say this financial advisor is quite alarmed that his clients could have been on the hook for information that the TPA, fund company, and plan custodian were not forthcoming to provide.

In addition, the use of revenue sharing funds has invented conflicts of interest, especially for producing TPAs, those TPA firms with its own financial advisory practice. The conflict is that the TPA/RIA would steer clients to revenue sharing funds since those funds will be used to offset administrative expenses, thereby making the TPA's fee look that much more attractive. While those in the business will protest my opinion, I did see it firsthand and the U.S. Government Accountability Office (GAO) did cite revenue sharing as a potential conflict of interest that may saddle plan participants with more expensive, mediocre funds.

While revenue sharing arrangements will certainly survive the implementation of fee disclosure, the practice may be curtailed somewhat if index funds and/or ETFs gain further ground in the 401(k) market. Less expensive investments gaining ground will put pressure on mutual fund companies that pay revenue sharing fees to lower their plan expenses. By lowering plan expenses, the assumption is that the fund companies will be pressured to cut back on the amounts of revenue sharing payments made to TPAs. That cutback may eliminate the "glow" that these revenue sharing paying funds have had in TPA preferred fund lineups and that may give further opportunities to less expensive mutual funds, index funds, and ETFs.

My friends in the industry will state that my views will be made obsolete by the fee disclosure regulations because plan sponsors and eventually plan participants will know all the fees behind the administration of their plan and all revenue sharing payments received. I disagree, because I believe that plan participants and sponsors will only be concerned with the bottom line as to the net expense of plan administration. While plan sponsors will know the revenue sharing payments, they will fail to understand the lost opportunities by using revenue sharing paying funds.

While I am not proposing that plan sponsors and advisors avoid revenue sharing paying funds, I want them to understand that many fund companies don't pay these fees and using these funds may actually cost them more to use in the long run than if they stuck with a less expensive mutual fund, an index fund, or ETF. Do you want to pick a plan investment on its merits or because the manager of the investment slipped some basis points to the TPA?

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