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# Defined contribution plan fee practices: revenue sharing considerations

Challenges of rebating revenue share to achieve the lowest cost

# Mercer believes the following principles should, where possible, be applied to fee arrangements

Please note that these "best practices" were developed based on general principles and without reference to any specific client or employer. The circumstances of any given client will be unique, and, as with any fiduciary decision, these client-specific circumstances should be taken intoaccount in determining whether and/or how to implement these practices. Accordingly, individually considered clients' decisions on these topics may not align with these best practices.

- **Disaggregate recordkeeping and investment management expenses**
- **Ensure that fee allocation is appropriate:** Within practical bounds, fees should be reasonable in relation to the work performed (e.g., charging recordkeeping fees based on assets under management may overcharge those with higher balances)
- **Ensure plan sponsors have fee transparency:** All fee arrangements and other revenue sources should be identified and fully disclosed
- **Clarify messaging for participants:** Participant disclosure is critical; participants should be able to understand the fees they are paying

The above principles typically lend themselves to a recommendation to eliminate revenue sharing. These principles are discussed more fully in the Mercer publication "Defined Contribution Plan Fee Practices."

Therefore, Mercer typically recommends that plan sponsors eliminate the use of revenue sharing within investment options to the extent possible. But there may be exceptions where it is not feasible or appropriate to entirely eliminate revenue sharing:

- For example, where an investment strategy is not available without revenue share, Mercer recommends that plan sponsors re-credit revenue sharing to those participants invested in the fund options that generate revenue sharing.
- There can be situations where lower "net of revenue sharing" costs can be achieved for participants by offering a share class that includes revenue sharing, and rebating those dollars back to the participants invested in that specific fund. However, this situation raises a number of other complications including transparency, participant communication, fairness of the rebate approach and the regulatory/legal environment

This paper addresses the complications resulting from focusing on the lowest net of revenue sharing expense ratio and how a Plan Sponsor may wish to navigate some of these challenges.

# Net of revenue share expense ratio explained (in theory)

The use of revenue sharing as a vehicle for paying recordkeeping fees, at least among larger plans, has largely become obsolete. However, many plan sponsors who do not need revenue share may still choose to use a higher-cost "retail" mutual fund share class and rebate back the revenue share in an effort to offer participants the lowest "net of revenue sharing" cost.

Consider the examples below which are based on actual cases but with the names removed, keeping in mind that the "Published Expense Ratio" is the fee that appears on all fact sheets and mandatory participant fee notices.

- **Fund A**'s published expense ratio for the "Institutional" share class is 88 bps including 10 bps of revenue sharing. This results in a "net of revenue sharing expense ratio" of 78 bps after the rebate. However, the plan could offer the higher-cost "Investor" share class (113 bps) with 40 bps of revenue sharing that would actually be 5 bps less expensive (73 bps vs. 78 bps) after rebates.
- **Fund B** has a zero revenue sharing "R6" share class with a published expense ratio of 71 bps. The plan could offer the "A" share class with a published expense ratio of 118 bps but with 50 bps of revenue sharing. Assuming revenue sharing is rebated that would result in a "net of revenue sharing expense ratio" to participants of 68 bps vs. 71 bps.

| | Fund | Share class | Published expense ratio | Revenue sharing | Net of revenue sharing expense ratio |
|---|---|---|---|---|---|
| FUND A | ABC International Value | Institutional | 88 bps | 10 bps | 78 bps |
| FUND A | ABC International Value | Investor | 113 bps | 40 bps | 73 bps |
| | **Difference** | | **+25 bps** | **+30 bps** | **-5 bps** |
| FUND B | XYZ Small Cap Growth | R6 | 71 bps | 0 bps | 71 bps |
| FUND B | XYZ Small Gap Growth | A | 118 bps | 50 bps | 68 bps |
| | **Difference** | | **+47 bps** | **+50 bps** | **-3 bps** |

For illustrative purposes only.

# Why in theory?

The calculation of the "net of revenue sharing expense ratio" assumes that the revenue share is credited back to the individual in proportion and at the same time as the net expense ratio is levied. In reality this does not happen; and plan sponsors should consider this issue as they decide which approach to use. Timing is often delayed, and the method of allocating back revenue shares varies across recordkeepers, and in some instances, rebates may not solely be allocated to those that generated the revenue.

## The dilemma

This situation creates an interesting question for plan sponsors. Is it better to seek the lowest net of revenue sharing expense ratio, or is it more prudent to offer the share class with the lowest published expense ratio (remember, participants see the published expense ratio)? Furthermore, does the practice of seeking the lowest net of revenue sharing expense ratio for participants pose additional fiduciary risks for the plan sponsor?

Plan sponsors and participants have greater awareness of the impact of fees than ever before. This is driven by broader availability of online data, research, tools and enhanced regulatory disclosures. Easy access to plan and fund data enables plan sponsors and participants to quickly compare investment fees charged by their DC plan to a spouse's plan, an IRA provider or a competing employer's plan. The upside of this greater transparency is increased marketplace competition and lower fees. The downside is that sponsors are under greater scrutiny and must consider the implications when selecting investment vehicles and mutual fund share classes.

## Fee transparency and clarity for participants

From the participant's standpoint, annual fee disclosures, fund fact sheets and third-party data sources (Morningstar, Form 5500, BrightScope, manager websites) in the public domain reference and benchmark the published expense ratio. There is no standard way to capture revenue sharing since the amount and way it is used varies from plan-to-plan and from recordkeeper to recordkeeper. Absent any plan-specific education on the treatment of revenue share, participants could rightfully conclude investment fees are higher than they should be, since they are not aware of the revenue share rebate.

Furthermore, the method in which revenue sharing is credited back to participants is often not disclosed and simply takes the form of a credit on their statement. Even if the plan sponsor does carefully explain the treatment of revenue share in plan communication, there are concerns as to whether participants actually read and digest this information, as most participant communications do not get the attention they deserve by participants.

The use of more expensive retail share classes (where the intention is to credit back revenue sharing) can also impact plan sponsor benchmarking. When comparing investment fees to peers defined by size, industry or asset class, revenue share should be "netted off" in the analysis. If revenue share is not netted off it will make the plan, and its options, appear more expensive and less competitive than they would be on a net basis.

Finally, there is a growing trend by plan sponsors to retain retirees in the plan as an alternative to higher fee retail-oriented products. Asset retention leads to greater economies of scale and lower fees for all plan participants. However, offering higher cost "retail" share classes with revenue share can make the plan look less competitive and lead to greater retiree distributions as a result.

**Conclusion:** The approach of rebating revenue sharing back to participants does create complications with fee transparency and clarity of communication with participants. There is no doubt that removing revenue sharing and focusing on published expense ratios is easier from a transparency and communication perspective.

## Mechanics of rebating revenue shares

The mechanics of charging a higher expense ratio and then rebating back a portion of those fees has logistical challenges that fall into the three general categories described below:

1. **Timing of rebates.** Revenue share may be received from the money manager four to six weeks after quarter-end. If rebated back quarterly, it may not be credited to participant accounts until the next quarter-end period, resulting in up to a two-quarter delay between initial payment of revenue share through the expense ratio and the rebate itself. This timing issue does have a monetary impact in the form of foregone earnings since the revenue share is not earning a rate of return.
2. **Missed rebates.** Participants may not receive a rebate if they take a withdrawal, a distribution or transfer out of the fund before the credit is posted. Sponsors can do an annual audit of the crediting process that will allow them to see this detail and then assess how to address the issue.
3. **Redistribution of participant assets.** The most problematic issue with rebating revenue share is the method in which the credit is administered, specifically, if revenue share is redistributed back to plan participants on a dollar-weighted or per capita manner:
   a. The amount of revenue share paid by a participant is based on the size of their investment in the fund. Participants with higher balances will pay more and those with lower balances will pay less.
   b. More importantly, those invested in a fund without revenue share, will pay zero. If revenue sharing is not allocated back based by fund, the reallocation will not be equitable.
   c. The same basic problem exists if the plan rebates back revenue share equally among all participants (per capita). Under this model, participants with small balances or those not invested in the funds with revenue share will receive a rebate although their accounts did not contribute to the revenue sharing.

   The preferred approach is to credit the revenue share paid directly back to the fund and/or the individual investor so only those investors in the fund receive the rebate.

**The above is summarized in the table below:**

| Rebate methodology | Description | Implications |
|---|---|---|
| **Dollar-Weighted** | Participants receive a rebate based on their account size relative to total plan assets, regardless of how they invested. | Participants with higher balances may receive a larger rebate even if they did not invest in the specific funds that included revenue share. |
| **Per Capita** | Every participant receives an equal share of the revenue share credit, regardless of how they invested. | Participants with higher balances who contributed to revenue share will have a portion of their revenue share contribution redistributed to participants who would otherwise not be entitled to the amount of that credit. |

**Conclusion:** If revenue sharing is being rebated back to participants, a key issue is assessing the reasonableness of the allocation methodology. A "net of revenue sharing expense ratio" approach implicitly assumes that revenue share rebates are perfectly allocated. In reality, the rebate methods have varying degrees of simplification and hence the implicit assumption will often not be true.

## Regulatory and legal guidance

The Department of Labor has not issued any guidance on the proper treatment of revenue sharing, or more specifically, if plans should strive for the lowest net expense ratio or net of revenue sharing expense ratio.

Fiduciary breach litigation can be the result of law firms reviewing regulatory filings looking for red flags or participants seeking legal representation if a complaint is not adequately addressed by plan management. As noted earlier, the practice of using higher-cost funds with revenue share to decrease net costs increases the visibility of the plan in the marketplace since Form 5500 and plan documentation are unlikely to adequately define the practice and hence will simply disclose high published expense ratios.

**Conclusion:** Using funds where revenue sharing will be rebated back to participants to obtain the lowest "net of revenue sharing expense ratios" will, in publicly available documents, disclose high published expense ratios. This can attract the attention of the plaintiffs' bar since the Plans' investment options will appear more expensive.

# Overall conclusion

Reinforcing general principles of ERISA's fiduciary standard of prudence, court cases have shown that the strongest defense for a fiduciary is to have an established and deliberate decision-making process that considers all material relevant facts, documenting the rationale for fiduciary decisions.

Given the discussion above, we can see that many clients would prefer an approach that treats all participants equitably and avoids the pitfalls addressed previously, and hence would gravitate to an approach that focuses on lowest published expense ratio approach. However, this is complicated if the net of revenue sharing expense ratio suggests a lower cost can be achieved. In these cases, if a lower net of revenue sharing expense ratio approach is available, the potential impact of this alternative should be considered, but along with the practical challenges of rebating revenue share.

# In summary

As set out at the beginning, Mercer recommends eliminating revenue sharing to the extent possible.

However, we know there will be circumstances where a plan sponsor may find it appropriate to retain revenue sharing. In such cases, it is important that the plan sponsor consider issues of fee allocation, fee transparency and clarity for participants. Focusing on net of revenue sharing expense ratios and relying on revenue share rebates does add more complexity that the plan sponsor should consider.

Regardless of which approach a plan sponsor uses, Mercer is a proponent of disaggregating recordkeeping and investment management fees, including revenue share, identifying all sources of revenue earned, and maintaining the highest level of transparency to the plan sponsor and the participant as possible.

Sponsors are encouraged to evaluate and document all practices that are periodically reviewed within the context of evolving best practice and recordkeeper capabilities. Additionally, the plan should review all participant communications to ensure the approach utilized is explained in simple terms that are easily understood by all participants, including those with a limited spectrum of financial knowledge. This will promote greater transparency and participant trust.

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