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*The Business Edge*[PRINT](#)**FINANCIAL PLANNING****Revenue Sharing: A Fiduciary Danger Zone**

By Brian Lakkides

According to a study by the Profit Sharing/401(k) Council of America, almost 80 percent of plan sponsors use a bundled 401(k) plan solution. If the employers you work with are among this 80 percent, they may be unaware they are violating their fiduciary responsibilities under ERISA. At the root of this problem is a fee gathering process known as *revenue sharing*.

**What is Revenue Sharing?**

Revenue sharing is a practice in which the investment options within a 401(k) "return" to the 401(k) provider a portion of the expense ratio that is collected. This practice is prevalent within the bundled plans (e.g., group variable annuities and mutual fund family based plans) marketed by banks, insurance companies and investment firms. Providers of 401(k) plans benefit from revenue sharing because it allows them to quote a very low plan services and administration fee—the most visible fee to the plan sponsor—during the sales process without actually reducing the total fees being charged.

This "loss leader" approach succeeds because the lack of fee *transparency* found in bundled plans facilitates the imposition of higher investment expense ratios that are then used to fund the revenue sharing arrangement. One can see this effect when examining the expense ratios for different share classes of a mutual fund frequently used in 401(k) plans. An example is below.

**Table 1: Comparison of Expenses Ratios for the Same Fund Across Share Classes**

Class A Share Class (5.75% front end load) used in Retail Accounts	Share Class commonly used in Group Variable Annuities	Share Class Used in plans not engaged in Revenue Sharing
0.63%	1.11%	0.43%

**What's the Problem?**

Although it's legal, revenue sharing is a questionable practice because—

- It misleads the plan sponsor about the true fee structure of the

plan.

- Internal mutual fund/investment option fees are increased and the bottom line cost is oftentimes higher than an “unbundled” plan with services delivered *a la carte*.
- The integrity and objectivity of the fund selection and monitoring process is compromised by the existence of this secondary income stream.

While these points should be reason enough to motivate plan sponsors to question the practice of revenue sharing and review the total fee structure of their plan, an even greater concern is that revenue sharing creates an environment ripe for unknowingly violating ERISA.

### **What’s the Risk?**

As a fiduciary, which can be a plan sponsor, or anyone responsible for making key decisions, one must be able to —

- Document the fees and expenses charged to and extracted from the plan (including “soft dollars,” 12b-1 and subTA fees, finder’s fees, wrap fees, mortality fees, market adjustments fees, and all other forms of revenue sharing).
- Identify all of the parties being paid with these fees and the services they provide.
- Determine if the fee being paid to each service provider is reasonable vis-à-vis the services being delivered *a la carte*.
- Monitor and document plan fees to assure that they are reasonable and remain so as plan assets increase.

Here are some of the key regulations to be aware of:

- ERISA §404(a)
- ERISA §408(b)(2)
- ERISA §406(a)
- UPIA§7
- DOL Reg. §2550.408b-2(d)

Unfortunately, the “not fully disclosed” nature of revenue sharing makes it nearly impossible for any plan sponsor to fulfill these responsibilities. In fact, a study by Hewitt Associates found that only 33 percent of plan sponsors have even attempted to calculate the total costs of maintaining their plan.

Although some plan sponsors may seek comfort in the fact that “everyone’s doing it,” this is not a prudent approach in today’s environment. This is especially true when one considers that the failure to monitor and control expenses is the leading cause of fiduciary breaches.

The increasing scrutiny levied on plan sponsors, coupled with the fiduciary risk resulting from the lack of fee transparency, is visible in three main ways:

1. ERISA litigation has increased at a rate of 25 percent per year over the past four years according to the [Foundation for Fiduciary Studies](#).
2. The Department of Labor has announced plans to impose fee disclosure mandates on employers.
3. Revenue sharing and the use of retail versus lower fee institutional share class mutual funds are key issues in the lawsuits alleging excessive 401(k) fees filed by employees against Lockheed Martin, International Paper, Exelon, Boeing and Deer & Co.

### **The Solution**

To ensure that your company is properly carrying out its fiduciary responsibilities, while minimizing exposure and costs of maintaining its corporate-sponsored retirement plan, be aware how a plan should be designed and monitored to guarantee transparency.

### **About the Author**

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