



Revenue Sharing in the 401(k) Marketplace

'Whose Money Is It?'

Soft dollar financial arrangements that affect millions of American workers and their retirement accounts.

This report will help you understand and control your exposure to this widespread practice.

Revenue sharing is the “big secret” of the retirement industry. This practice has created an environment that makes it hard for employers and employees to understand the true cost of their retirement services. Gross inequities can exist for both plan sponsors and participants.

Revenue sharing is a blanket term for the practice of transferring “soft” dollars between mutual funds and administration service providers who support 401(k) and other types of defined contribution plans.

Until now, there hasn't been a comprehensive source of objective information about the true sources and uses of revenue from mutual funds in support of retirement programs using mutual funds and related investment products. In spite of the best efforts of industry groups, regulatory bodies and service providers, there has not been an unbiased description of a practice that impacts many workers and taxpayers.

"Most employers, even sophisticated, middle market companies, don't have the information, skills, tools or time to fully understand and manage the expense/revenue realities of their 401(k) plans. Our clients typically save a third or more of their total costs (including asset based fees) when we help them to aggressively manage the total economic benefit of the vendor/plan relationship."

*"There is no such thing as a free lunch but at least you can find out the price before you get the check."
(Pg 16)*

"Most plan sponsors and participants don't understand fees from the investment community. It is clear to us that they don't know how much they are paying their providers." (Pg 17)

This report is designed for the following audience:

- Retirement Plan Sponsors
- Finance Managers
- Human Resources & Benefits Professionals
- Retirement Plan Participants
- Journalists
- Regulators & Legislators
- Investment Advisors & Asset Managers
- Registered Representatives
- Attorneys & Consultants
- Retirement Service Providers

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An expanded version of this report - Revenue Sharing, The Inside Edition – is available from McHenry Consulting Group, with enhanced detail and an insider's look at how vendors and plan sponsors can best serve their clients and plan participants. For additional information, write us at media@mchenryconsulting.com or call 1-800-638-8121. Download additional copies of The McHenry Revenue Sharing Report together with its companion software package, the PlanTools investment policy statement tool (PlanToolsSM IPS), may be found free of charge at www.PlanTools.com. Reprints are available by email at media@mchenryconsulting.com or call 1-800-638-8121.

Introduction

Have you ever wondered how 401(k) plans got so popular?

Three possible reasons:

1. Plan sponsors and plan participants realized the benefits of defined contribution/401(k) (as opposed to defined benefit) plans that were primarily funded by workers, not employers. Given the coming of age of self-determinant baby-boomers, it was a marriage made in heaven.
2. High returns from the stock market have helped build assets that reinforced the concept of saving and investing with employees. Main Street found Wall Street and millions of American workers were investors for the first time.
3. Service providers and mutual funds knew a good thing when they saw it and focused attention on this new, pre-tax source of investment assets.

The current environment:

Hidden costs? – “Bundled” services have resulted in camouflaged pricing. In most cases, administration and service expenses are paid from an internal charge against plan assets invested in mutual funds.

Lack of information & control – In most cases, workers don’t know how much they are paying for their services and how much they may be subsidizing their coworkers. Service decisions are made by employers or plan sponsors – participants have little meaningful input in most cases.

Soft dollar compensation – It has been estimated that 85% of retirement industry revenues are asset-based (and not billed explicitly).

A big pie – An estimated \$ 800 billion was invested in mutual funds by 401(k) plans at the end of 1999. Of that amount, \$500 billion or over half, is estimated to be invested through non-institutional funds with “retail” expense charges.

A large slice – No one really knows how much money changes hands behind the scenes, but the authors estimate that subsidy transfer payments may total as much as \$1.5 billion each year, flowing from mutual funds to administration service providers that support 401(k) plans.

Expense transfer – Payment for plan services has slowly moved from plan sponsors to participants, who now pay most administrative and service costs.

Funding disparity – In the “new world” of 401(k), deposits to accounts are generally a function of how much the employee chooses to save, plus any employer match or contribution. The result is a wide range of variation between the low and high balance account holders, with a potential impact on how 401(k) service costs are allocated and recovered by vendors.

Fair pricing? – Older employees with relatively larger account balances may be subsidizing the service costs of their lower-balance compatriots.

Unfair pricing? – When changing jobs, most “high balance” employees roll over their prior plan balances to IRAs. As a result, those assets are not available to their new employer’s plan to help generate revenue credits to pay expenses. Long-term employees may be disadvantaged.

Revenue sharing is a part of the benefits landscape.
All interested parties need to know how it works.

“For 70 to 80% of plans – typically those of the smaller and less sophisticated employers – revenue sharing is ‘invisible’ because the responsible fiduciaries do not know how or where to look for it or, for that matter, that it even exists. Nonetheless, they have a fiduciary duty to investigate and understand the expenses being charged to its assets.” (Pg 14)

History

(k) Adoption The first 401(k) plan was installed in 1981 by Ted Benna, a pension consultant in Pennsylvania. What many considered to be an aggressive interpretation of an obscure section of the code was quickly embraced by employers as an inexpensive, high profile benefit. Within three years there were about 17,000 plans on the books; by year end 1999 the plan count exceeded 300,000.

The move to mutual funds and participant direction With the huge influx of new employee-directed money came the need for investments participants could easily trade and track. Variable annuities and mutual funds, and the systems in place to run them, had the ability to handle employee-directed, multi-fund 401(k)s. Insurance, mutual fund, bank and brokerage sales forces were mobilized to sell this great new concept.

Impact of daily valuation Prior to the advent of daily valuation 401(k) plans in the mid and late 1980s, fee-for-service investment management, plan administration and actuarial consulting services were the orders of the day. Account values were reported to participants once a year, and most defined contribution (DC) plans were managed as pooled accounts. With the evolution of 401(k), participant balance inquiries became available on a daily basis, but many transactions (such as fund exchanges, loan requests and distributions) had to wait for the next full plan valuation. Full conversion to daily valuation of assets and plan rules transformed plan administrators from consulting experts into providers of high volume, repetitive, low-margin services.

Recordkeeping subsidies Though mutual funds could handily service retirement plan participants, providing customer service, communications and trading were prohibitively expensive in the DC realm. Worse, exporting data to ERISA plan administration systems and processing yet another participant report was error prone and a terrific duplication of effort.

Consulting firms like Hazlehurst Associates (now Northern Trust Retirement Consulting) and Hewitt Associates appear to have been the first to solicit mutual funds for plan-level revenue rebates sometime in the early 1990s. They already maintained all the information necessary to administer, recordkeep and service plan and participants, and were performing the highly repetitive, low-margin activities associated with managing and servicing retirement plans, saving the fund complexes the effort and expense.

Such firms simply asked for some help in underwriting the cost of services for which mutual funds were collecting compensation at the fund level. Into this sub-contractor environment, revenue sharing was born.

Retail "supermarkets" In 1992, Charles Schwab created the prototype investment source for the multi-fund family 401(k) through a new retail offering. Retail investors were able to invest in many different fund families and to receive a single statement from Schwab. Referred to as their no transaction fee (NTF) program, Schwab eliminated transaction costs, supporting the platform on revenue generated by fund distribution commissions and servicing fees. Originally offering about 100 funds from fewer than thirty families, it grew to over \$50 billion within five years. Now called OneSource™, the product includes over 1,800 funds, 250 families and \$300 billion of assets. This exponential growth has been consumer driven, as the demand for more investment flexibility has been met.

Size of DC marketplace Of the over \$2.5 trillion invested in DC plans in the United States at the end of 1999, over \$1.2 trillion was invested in mutual fund assets, of which \$777 billion was in 401(k) plans. The bulk of the balance represented assets of 403(b) plans for non-profit institutions. Fifty-eight billion dollars of new money flowed into DC plans that year, \$42 billion of which is attributed to 401(k)s.

NOTE: Some confusing terms used in the retirement industry include "Plan Administrator" (a role defined by pension law, usually filled by the employer); "plan administrator", a generic term used to identify the provider of plan recordkeeping and administration services; and "third party administrator, or TPA", a plan administrator unaffiliated with a mutual fund, brokerage, bank or insurance firm, usually thought to be most closely affiliated through the relationship with the plan sponsor.

"If you unbundled administration and investment-related costs and the employer bears the non-investment expenses, you can then present to the employee 'here is your cost of investing' – (hopefully) at institutional rather than retail levels. It would be great to have the employer pick up all administrative costs." (Pg 14)

"The practice of revenue sharing is neither inherently good nor bad, it's just one of many ways to price and pay for 401(k) plans. The larger issue is that most participants continue to operate under the false notion that their 401(k) is 'free.' That's a myth." (Pg 17)

Revenue Sharing Basics

How are plan services paid for? There are three sources of payment for plan administration expenses: 1) employer pays by check, 2) plan pays from assets on an unallocated basis, 3) participant pays from assets on an allocated basis. In practice, all three may be combined.

What is revenue sharing? Revenue sharing is a blanket term for the practice of transferring asset-based compensation from investment management providers (such as mutual funds) to administrative service providers who support 401(k) and other types of defined contribution plans. Generally, this term applies to internal transfers within a bundled or alliance offering.

How does revenue sharing work? Under securities law, mutual funds may share a portion of their revenues with retirement plan recordkeepers and other service providers who support a 401(k) plan that is a fund shareholder. Simply stated, money is taken from mutual fund account values by the mutual fund and then used to pay expenses of the fund. These expense items may include accounting, marketing and other administrative costs.

Who does it? Almost every investment and administration service provider engages in this activity to some degree. It is virtually impossible to compete in the 401(k) marketplace without subsidies to help offset service costs, as provided by asset-based revenues.

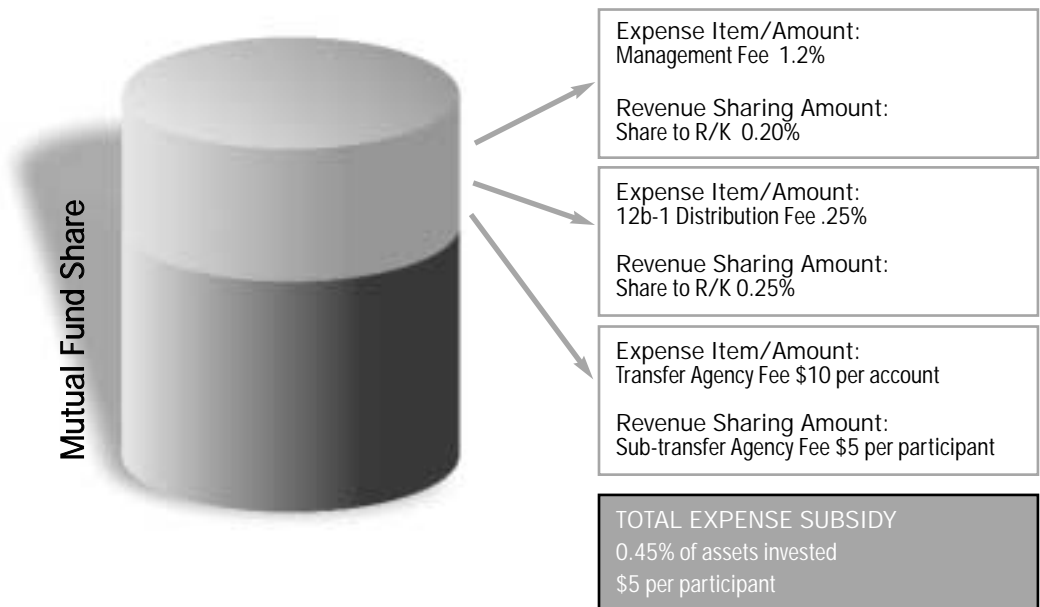
Who does it affect? Most 401(k) plans offered by middle market and smaller employers are supported by service providers who use revenue sharing to reduce the apparent or "above the line" costs of plan administration. Given over 40 million 401(k) plan participants in this country, it is safe to say that millions of American workers are affected by this practice.

Why does it matter? Most plan participants have no direct control over the selection of plan service providers. Their employers make decisions that may have a direct impact upon expense factors that can reduce their investment returns through increased or inappropriately allocated expenses.

"Fees should not be hidden in asset charges. Plan sponsors – particularly smaller companies – need full disclosure. The issue is how much they are paying and is it a fair amount for the services they are receiving?" (Pg 14)

Mutual Fund Expenses & Revenue Sharing

Hypothetical Example:



Revenue Sharing Basics

How much do they take? Since arrangements vary from fund to fund and provider to provider, it is hard to say, but revenue transfers may range from 1/10 of 1% of account balances to 1% or more. As an example, a participant with a \$300,000 401(k) balance invested in funds that pay revenue sharing may effectively have $\frac{3}{10}$ of 1% of her account value diverted at the fund level to pay plan expenses, or \$900 per year.

How much does it cost to deliver recordkeeping and related services? Industry estimates vary, but one service provider suggests that \$100 per participant per year is a reasonable price for all administration, communications, education and related services. Another vendor will actually commit to provide such services for an annual fee of around \$150 per participant per year.

What happens to revenue sharing in excess of the costs of delivery? In many cases revenues are pooled at the plan level to pay expenses generated by other participants with lower balances. With average 401(k) balances in the range of \$16,000 per participant, higher balance participants are often subsidizing their fellow employees' cost of participation.

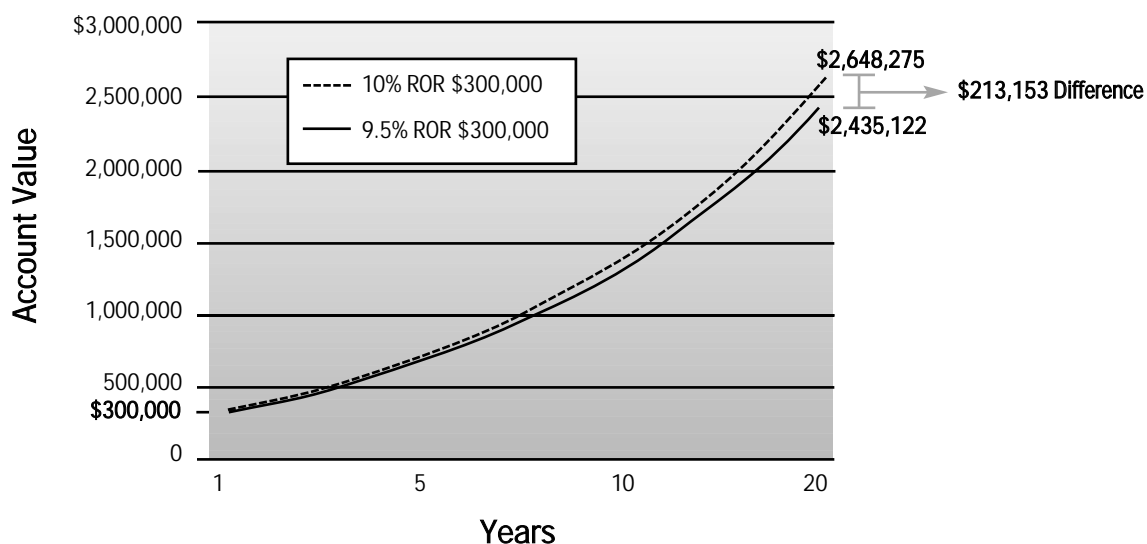
What is the effect of revenue sharing upon a participant over time? The power of compounding is clear. A 45-year old participant with a hypothetical rollover balance of \$300,000, continued 401(k) contributions of \$10,000 per year, and a $\frac{1}{2}$ of 1% difference in return (through investment in a fund with asset charges supporting revenue sharing) could reduce her age 65 account balance by over \$213,000, at an assumed gross annual return (before revenue sharing) and continued 401(k) contributions of \$10,000 per year.

This difference represents over $\frac{2}{3}$ of her original rollover value, due solely to higher expenses.

What can a plan sponsor do to make sure they are not overpaying? To adequately discharge their duties, plan sponsors should become knowledgeable about service pricing and revenue sharing practices in the retirement industry. Any decision maker should understand the variables that affect vendor costs and fees and be prepared to negotiate on behalf of employees.

What are rebates? These are payments made by the mutual fund to a service provider by check and disclosed to the plan or plan sponsor, for payments outside of a bundled service package.

"Employers are asking suppliers for more efficient pricing, resulting in greater value for plans and their participants. With our clients, revenue sharing, expense subsidies and rebates are all 'on the table' as we work together to help them discharge their fiduciary obligation to act in the best interests of their employee/investors." (Pg 16)



Plan View

Variables that most directly affect plan service pricing include:

- 1. Average plan participant balances**
(for example, \$75,000/participant)
- 2. Revenue-sharing “payout” received by the service provider**
(such as 40 bps per year)
- 3. Plan provisions and operational complexities**
(number of plan money types or sources, contribution and matching formulas, multiple sub-groups or affiliate companies, multiple payrolls or multiple pay periods, etc.)
- 4. Issues related to employee education and communications**
(number of work locations, participant access to the Internet, investing experience, etc.)

Vendors take all of this data into consideration when preparing a fee schedule or offer of services to a plan. Some make use of this information in a pricing software application that tells them how much they will make from the relationship. Other supporting variables include fund selection (which impacts #2), client staffing levels and their skills (which can help address #3), employee turnover rates (which affects #4), etc.

If the service provider cannot realize enough income from asset-based revenues of the funds used, it will ask for additional, hard fees. If the revenue from asset-based sources is adequate, the vendor may offer to waive hard/direct costs, relying solely on fund-generated revenues. This moves the burden of all expenses to the assets of participants.

Let's assume that a plan based on the examples above had 100 participants, with average participant balances of \$75,000 and that the 'bundled' service provider (offering investment, recordkeeping, administration, participant education and service) used funds that paid $\frac{4}{10}$ of 1% (or 40 basis points or 'bps')* to offset those costs. An internal accounting would look like this:

* Industry jargon is a tradition in the retirement business. One example is "basis points". One basis point is equal to 1/100 of 1%, or 1/100 of 1/100. In the paragraph above, $\frac{4}{10}$ of 1% is equal to 40 basis points, or 40 bps. It is a shorthand method that efficiently conveys percentages in finer detail, without having to use decimal notation.

Plan View

Plan Assets	\$ 7,500,000	(100 x \$ 75,000)
Revenue Available to Offset Plan Expenses	30,000	(\$ 7,500,000 x ⁴⁰ / ₁₀₀ of 1%)
Vendor's Projected Cost of Service (low average rate)**	- 15,000	(100 participants @ \$150)
Profit/Surplus to Vendor	\$ 15,000	

With this information in hand, the plan sponsor in the case above might seek to negotiate lower cost fund share classes or to obtain a form of rebate to pay for other plan expenses. On the other hand, the service provider might be able to show that their cost of delivering the service is higher than estimated, or that it deserves the profit margin indicated through extraordinary service or value-added.

The excess implicit above usually grows over time, providing a built-in revenue adjustment for the service provider.

In negotiating with one's vendor, it might help to have an understanding of how other plans are structured as to items 1 through 4 above. Such information is often proprietary, but some elements are available through publicly available plan filings with the IRS.

Information about any 401(k) can be had from its most recent tax filing, including plan asset value, number of participants and often other nuggets as well. This information is available through a free research service at www.PlanTools.com. All you need is the name of the firm in question.

** Industry sources suggest that the real cost of providing bundled services to a participant is around \$100 to 150 per year. Let's assume this to be the case and add another 30 to 50% as corporate overhead and/or profit. This gives us a working range of \$130 to \$225 per year as a per-participant cost of service.

"I believe a fully-disclosed, flat-fee pricing method is better for everyone involved. The sponsor can be assured that servicing costs remain capped and competitive both at the time they make their buying decision and in the future."

"... the participant knows that as their account balances go up, their administrative fees remain the same. With flat-fee pricing, the more you save, the more you keep." (Pg 17)

Participant View

In order to understand the impact of economics at the participant level, we first need to look at the context – how do a participant's assets relate to the plan's assets as a whole? Here is a view from the participant's perspective:

1. What is my balance?

How much do I have in the plan and how does that compare to the balances of my fellow workers?

(Let's say I am an older, long-term employee who has saved and invested through the plan for fifteen years. My latest statement shows \$300,000 of value and I know that I am in the top 20% of participants in terms of account balance.)

2. What funds do I hold?

How much does my fund take (or pay) to offset the cost of plan services?

(All of my account is in funds that appear to be readily available through the fund family or through retail "supermarkets" without commission. In the retail world, they do not have high initial minimum purchase requirements.)

3. Am I a 'low maintenance' client?

How much effort and expense do I create for the plan service provider?

(I use the Internet for all communications and have even asked not to receive paper statements. I do not require support via the 800# customer service desk of the plan vendor.)

4. Am I an 'experienced' investor?

Do I understand investing basics and am I able to make decisions with limited on-site or telephone support?

(I think so, since I have been a successful investor in both stocks and bonds and mutual funds for many years. I make my own decisions and do not change investments or reallocate my funds very frequently. When I do, it is for good reason, either because my goals have changed or there has been fundamental change in the long-term economic outlook.)

5. Did I roll other assets into the plan?

Did I bring assets to the plan that help pay expenses of the plan?

(Yes, as around 1/3 of the balance in my account represents a rollover from a prior employer's 401(k) plan.)

6. How do my assets benefit others?

Do I have (on average) larger account balances than my coworkers? How do I (and my fund allocation) compare, relative to revenues generated and used to pay plan expenses?

(I think my relatively high balance and use of "retail" funds produce a significant amount of revenue for the plan service provider.)

To answer these questions, a participant would need to know the general allocation of assets of other participants by fund (and revenue generated) as well as the dispersion of assets.

Participant View

Here are the steps to understand one's role as a participant in payment of plan expenses:

1. The first step is to research and estimate what is a likely level of income to the plan service provider, from mutual fund revenue sharing. Publications, reporting services and a financial advisor might be good sources. For this discussion, let's use the 40 bps figure above.
2. Next, we need to estimate the cost of my account service, to the vendor. Since I am a "low-maintenance" participant, let's assume that I am at the very low range of the scale, at \$130 per year.
3. Finally, we need to estimate the dispersion of plan assets by participant, not individually, but to get a sense of how many new and relatively low balance employees are participating in the plan. Just because the average balance is \$75,000, it doesn't necessarily follow that there are 100 participants with \$75,000 each. The reality is that there are probably a large number of employees with balances quite a bit lower than \$75,000.

For this example, let's say that the three owners of our company have significantly higher balances because they "rolled in" balances from other retirement plans, to our 401(k). Each one has an account value of \$1 million. Further, let's say that the longest-term employees (other than the owners) consist of ten employees with balances of \$300,000 each. The balances of the employees (87 of them) have average balances of \$17,241 each. Plan populations don't really look like this, but then again, 'average' participants don't often exist either.

Let's look at the revenue sharing/service economics for our account, an average account and the accounts of our 87 less endowed co-workers:

"My" Account Balance	\$ 300,000	(per participant statement)
Estimated Revenue Available to Offset Expenses	1,200	(\$ 300,000 x 40/100 of 1%)
Vendor's Projected Cost of Service (lowest rate)	-130	
Excess Revenue Produced by My Account	\$ 1,070	
"Average" Participant Account Balance	\$ 75,000	
Estimated Revenue Available to Offset Expenses	300	(\$ 75,000 x 40/100 of 1%)
Vendor's Projected Cost of Service (low average rate)	-150	
Excess Revenue Produced by "Average" Account	\$ 150	
"Lower 87" Participant Account Balance	\$ 17,241	
Estimated Revenue Available to Offset Expenses	69	(\$ 17,241 x 40/100 of 1%)
Vendor's Projected Cost of Service (high average rate)	-200	(this assumes higher effort/expense)
Indicated Loss to Vendor Produced by "Average" Account	- \$ 131	

What we can see from this exercise is that somebody has to pay the service expense of those lower balance participant accounts. If the plan is paying for services only through asset-based revenues, then the top 13 account holders are paying a significant portion of the cost for the other 87 participants.

Some industry observers suggest that high balance participants should subsidize their lower balance coworkers as an aid or "leg up" to younger workers who are just starting out. Others suggest that the system is not fair, equitable or well disclosed.

One point that bears consideration, though, is that some 75% of retirement plan distributions over \$100,000 are rolled over into IRAs and most of the balance is taken as cash distributions. Only a small percentage of plan distributions are rolled into a new employer's retirement plan. Workers change employers relatively frequently and the implications of the rollover IRA should be considered in this debate.

A low 401(k) balance does not necessarily mean the employee is young or without other assets – it sometimes means that the employee found more choice, lower cost or greater value through an Individual Retirement Account (IRA) or some other investment vehicle.

Sources of Revenue Sharing

Fund management fees Mutual funds may, at their discretion, share a portion of their management fee with third party recordkeeping or distribution service providers. Per prospectus, this expense item is collected by the fund management or advisor for services, including investment management and management of the affairs of the fund.

Finder's fees Finder's fees represent compensation in the form of a percent of initial investment, typically .25 – 1% of new money, paid out of mutual fund companies' own resources. They are not a sales charge deducted from plan investments. Some funds pay finder's fees only to securities dealers as a commission, others treat them as service fees, and compensate service providers in the absence of a broker on an account.

SEC Rule 12b-1 plan of distribution and shareholder service fees Adopted by the Securities and Exchange Commission (SEC) in 1980, this rule permits mutual funds to charge shareholders up to $\frac{3}{4}$ of 1% (75 basis points, or bps) for distribution costs and 25 bps for account service fees against fund assets, to be incorporated in fund expense ratios.

Sub-transfer agent fees These fees represent a portion of the compensation normally paid to fund transfer agents diverted to those performing shareholder recordkeeping, recording daily activity and handling all shareholder servicing (from issuing account statements, confirmations and tax statements to maintaining customer service departments on behalf of the funds).

Most of these duties fall to the plan's administration provider in a participant-directed, defined contribution plan, and the administrator can be compensated for taking over this function if arrangements are made and contracts negotiated. Such revenues take the form of asset-based fees, fixed fees on a per-participant basis, or a combination of both.

Multiple share classes These were introduced as an alternative to front-end load sales charges to compensate distribution and service firms. Shareholders pay the costs based, generally, on whether they are "retail" (through a broker), or "institutional" (without broker involvement) customers, tolerance for front-or back-end sales charges, or the level of service required. A typical example might be a hypothetical fund offering with six share classes:

"Institutional" class: no 12b-1, no service fee, expense ratio of 50 bps (or $\frac{1}{2}$ of 1%)

"Investor" class: no 12b-1, 10 bps service fee, expense ratio of 60 bps (or $\frac{6}{10}$ of 1%)

"Trust" class: 25 bps 12b-1, 25 bps service fee, expense ratio of 100 bps (or 1%)

"A" class (retail): Front-end load of 5%, 25 bps 12b-1, 25 bps service fee, expense ratio 125 bps (or 1.25%)

"B" class (retail): Back-end load of 5% Yr. 1, 25 bps 12b-1, 25 bps service fee, expense ratio 200 bps (or 2%)

"C" class (retail): Front-end load of 1%, 100 bps 12b-1, 25 bps service fee, expense ratio 200 bps (or 2%)

Forms of Revenue Sharing

Asset based revenues These sources of income to service intermediaries vary considerably:

Retail load funds may have a front-end sales charge or a withdrawal charge, called a contingent deferred sales charge (CDSC) upwards of 5% on initial investments in the fund family, payable to brokers, or if traded with sales charges waived may pay a finder's fee on initial investments starting at up to 1%. In addition, revenue sharing of $\frac{1}{10}$ of 1% to over 1% is paid on total assets.

Retail no-load funds are defined as funds having no sales charges and a 12b-1 distribution fee of $\frac{1}{4}$ of 1% or less. They pay up to $\frac{1}{2}$ % on total fund assets and, in addition, some pay a finder's fee of up to $\frac{1}{4}$ of 1%.

Institutional funds (both low-cost mutual funds and separately managed accounts and trust vehicles dedicated to retirement plan clients) may make available limited revenue sharing up to $\frac{1}{5}$ of 1% on a case-by-case basis. These revenue streams can be subject to declining compensation scales as assets increase and break-points are achieved.

Per-participant revenues These payment formulas have a broad range, as well. Compensation varies from \$3 per participant position (owning shares in a fund) in a given fund family to \$22 per position. Some funds compensate for all positions, others cap at, say, three positions within the family for any given participant. Hybrid approaches, intended to reduce exposure to adverse selection, have formulas with pay, for example, \$10 per position capped at 10 bps on total plan assets. Some families pay higher amounts, if personal information is shared by the TPA, on a sliding scale (for example \$3 if participant counts only are provided; \$12 if home addresses and social security numbers are provided).

Retirement "supermarkets" Like their retail cousins, these permit cross-family trading on a daily basis, with most offering funds under revenue-sharing contracts to support the product. They provide trade order entry and settlement support to in-house retirement plan platforms or those of TPAs who link their recordkeeping systems to the supermarket for the services.

Brokerage compensation Retail mutual funds typically pay brokers and their dealers initial sales charges levied on initial investments (front-end loads) or contingent deferred sales charges against share redemptions (back-end loads, or CDSCs) as payment for selling funds to retirement plans with less than \$1 million in assets. Plans with over 100 participants or whose assets exceed \$1 million can usually find a retail fund family which levies no sales charge. In that case, fund distributors often pay a commission, or finder's fee, of up to 1% of "new money."

If a dealer of record takes a reduced payment or waives the finder's fee in connection with a retirement plan, a CDSC may be waived. In addition, a fund may pay the fund underwriter (or others) a 12b-1 distribution payment as reimbursement for expenses incurred for the promotion and distribution of the shares of the fund.

The bottom line here is that there are a lot of ways for an administrator, service provider or advisor to get paid, and that may present a conflict of interest affecting their advice and counsel to clients.

Current Trends

Reasonable compensation Expenses must be “reasonable” for plan sponsors to meet their obligations under US Department of Labor (DoL) regulations: “excessive” compensation in excess of amounts ordinarily paid for like services by like enterprises under like circumstances, will not be “reasonable compensation.” Ninety (90) percent of sponsors cite cost as the key consideration in selecting outsourcing vendors for plan administration, but research shows that plan sponsors are unable to determine plan costs.

Clearly, plan sponsors are handicapped in meeting their fiduciary duty to act prudently and for the exclusive purpose of providing benefits to the participants and their beneficiaries and defraying reasonable administrative expenses.

Disclosure Industry efforts have been made to provide more information to plan sponsors and participants. The results have been mixed. Many commentators focus upon all costs – both investment management and administrative expense – as a percentage of total plan assets, although such measures leave out an important variable. Percentage expense figures are relatively useless without some connection to the services being delivered and the average participant balances.

The SEC developed a standardized mutual fund expense analysis format, encompassing a fee table which accommodates expense ratios, 12b-1 and “other.” They “recommend that information about the dollar amount of fees and expenses be presented in a fund’s shareholder report, so that investors can evaluate the information alongside other key information about the fund’s operating results, including management’s discussion of the fund’s performance. In effect, shareholders would be able to evaluate the costs they pay against the services they receive.”

While the regulations don’t discuss revenue sharing, a component part of net expenses, nor the payee of revenue sharing, there has been some industry initiative in identifying plan costs.

The Profit Sharing/401(k) Council of America (PSCA)

PSCA’s “Profit Sharing and 401(k) Plan Cost Disclosure Worksheet,” attempts to cover costs and revenue sharing income. Its philosophy is self-described: “Rather than comparing individual fees, you should look at the total cost.”

The Pension Welfare and Benefits Administration (PWBA)

PWBA is a unit of the Department of Labor and it offers a 401(k) Plan Fee Disclosure Form which addresses fund expense ratios only and does not provide for analysis of revenue sharing or its impact upon plan service costs. It also has available a set of brochures for plan sponsors and participants, helping to educate how plan fees work.

In another area of endeavor, PWBA has implemented a program under its Strategic Enforcement Plan (StEP) which directs its field offices to focus upon abusive practices committed by specific service providers. Specifically as an example, when a third-party administrator (including bundled programs) has systematically retained an undisclosed fee, generally the focus will be on the third party administrator.

DoL field offices have been encouraged to allocate appropriate resources to the targeting and investigation of these issues or entities.

There is no standard against which a trust fiduciary can determine “reasonable” versus “excessive” costs. There is no grid, literally or figuratively, for comparing “like” services provided by “like” enterprises under “like” circumstances. “All-in” disclosure statements have been advocated by some in the industry, and The Vanguard Group’s new full disclosure plan sponsor “All-In Fee Report” will assist fiduciaries in this regard.

Current Trends

Yet, in the midst of this, investment/service costs and investment style have been established as the only statistically predictive fund factors, and cost is “the most controllable” factor in investment selection; it may be reasonable for fiduciaries to focus on cost as the key component which can be monitored with the expectation of meeting fiduciary requirements. That said, it seems reasonable to separate investment management expense from recordkeeping, administration, communication and participant service expense.

Government reporting Vendors are not required to report revenue sharing or use of funds to their plan sponsor clients or to participants. The only reporting requirements for revenue sharing or commissions fall to the plan, and are found on IRS Form 5500.

The DoL recently issued guidance on payment of plan expenses: “DoL has... consistently taken the position that while expenses associated with a fiduciary’s administration of a plan may be paid from the assets of the plan, expenses related to “settlor” decisions must be borne by the employer.” “Settlor expenses” are those deemed to be the responsibility of the employer, not the plan itself.

The DoL’s stance on revenue generated by a participant’s share of plan assets is diverted to payment of such expenses? Again, time will tell.

Litigation Over the last several years, several significant cases have been brought, claiming breaches of fiduciary responsibility based upon 401(k) plan investment fund selection, in some cases related to retail versus institutional fund use. In one such case, a substantial amount was paid (over \$25 million) as part of a negotiated settlement. Others are still pending.

While three or four high-visibility court cases do not represent a tidal wave of litigation, some observers suggest that in the current environment, more may be expected, with some potential impact upon the decisions of other retirement plan fiduciaries.

Net pricing Some vendors provide “net” pricing where they do not accept any revenue from fund companies, but are compensated based upon a per participant monthly fee representing all services.

Directed revenue sharing A new model is one in which all revenue realized by the service platform is placed in a side “clearing account” and those funds may only be disbursed at the direction of the plan or its trustees, to pay expenses of the plan.

Consultants Many plan sponsors rely upon consultants and other advisors who bring information and knowledge to help them make good decisions and to protect their participants’ interests. Unfortunately, some who hold themselves out as counsel to employers and plan sponsors may have vested and undisclosed conflicts of interest that affect their objectivity and perspective.

Industry Insights

In our research and documentation of the topic of revenue sharing, the authors found a number of industry observers and service providers willing to speak to their view of revenue sharing and expense rebates. Following are their contributions to this exciting and important public discussion.

The originator Ted Benna is acknowledged as the “father” of the 401(k). His firm designed and implemented the first such plan twenty years ago. He sees a great opportunity for plan sponsors to better serve employees.

“If you unbundled administration and investment-related costs and the employer bears the non-investment expenses, you can then present to the employee ‘here is your cost of investing’ – (hopefully) at institutional rather than retail levels. It would be great to have the employer pick up all administrative costs.”

The advocate Established in 1947, The Profit Sharing/401(k) Council of America (The Council) is a national, non-profit association of 1,200 companies and their 3 million employees. The Council advocates increased retirement security through profit sharing, 401(k) and related defined contribution programs. Council President, David L. Wray, knows the issues faced by plan sponsors.

“Fees should not be hidden in asset charges. Plan sponsors – particularly smaller companies – need full disclosure. The issue is how much they are paying – and is it a fair amount for the services they are receiving?”

In the trenches Fred Reish is a partner of the law firm of Reish Luftman McDaniel & Reicher, and serves as the Managing Director of the firm. He specializes in employee benefits law. During his long and diverse career, Fred has seen retirement law from all sides. His views on revenue sharing are clear:

“Fiduciaries must know and understand plan expenses to meet their obligations under ERISA. They must engage in a prudent process, and are obligated to make a diligent inquiry into the plan’s net costs.”

“For 70 - 80% of plans – typically those of the smaller and less sophisticated employers – revenue sharing is ‘invisible’ because the responsible fiduciaries do not know how or where to look for it or, for that matter, that it even exists. Nonetheless, they have a fiduciary duty to investigate and understand the expenses being charged to its assets.”

“The perfect provider would say, for example, ‘I get 25 basis points in revenue sharing on this plan, and I can do all the work for 20; I’ll restore the 5 basis point difference to the plan.’”

Public policy perspective Established in 1978, the Employee Benefit Research Institute (EBRI) is a nonprofit, nonpartisan organization committed exclusively to data dissemination, policy research, and education on economic security and employee benefits.

In commenting on the DoL’s Request for Information for the upcoming White House-sponsored 2001 SAVERS Summit, EBRI President, Dallas L. Salisbury opined that:

“A fifty basis point difference (or one half of one percent) in rate of return is absolutely material to participants’ retirement benefit, when viewed over the long term.”

Industry Insights

In the Vanguard The Vanguard Group, the only client-owned mutual fund company in the world, is an industry leader, having provided innovative retirement plan administration solutions and high-value investment management programs for retirement plan sponsors for more than twenty years.

Consistent with its high-value leadership, Vanguard is at the forefront of providing candid fee disclosure to its clients, aided by its "All-In Fee Report," which clearly documents client plans' operating expenses in three categories:

Asset-Based Fees - Reflected in fund operating expense ratios, typically the largest portion of plan's costs.

Service Fees - Costs of primary administrative and recordkeeping functions provided by Vanguard, assessed as a flat per-participant fee or per-plan fee.

Fees for Additional Services - These special costs may include customized communications or outsourcing services. They are typically billed to the plan separately as these services are used.

F. William McNabb heads Vanguard's Institutional Investor Group and suggests that when it comes to 401(k) services:

"Value is the issue, not simply basis points."

"Vanguard strives to create wealth for its clients by offering well diversified, high-value investment portfolios, and effective, customized education programs."

"Vanguard's goal is to ensure that its clients receive a broad range of flexible, high-quality retirement plan services at the lowest reasonable all-in cost."

You can bank on it One organization with a traditional approach to the issue of 401(k) pricing and asset-based revenues is Union Bank of California, NA, which serves over 3,000 defined contribution and defined benefit plans. "UBOC" as it is known, approaches revenue sharing from funds on its platform as a means to an end – just one of a number of variables that are on the table when building a common service economic model with clients. Piet Westerbeek, Executive Vice President of UBOC's Institutional Services & Asset Management Division commented on revenue sharing:

"(It) is a tool we use as part of a service-driven approach to meet plan and participant-level needs."

"With each client, we address the impact of all decisions upon the net cost of delivery, including fund selection. That includes specifics of cost subsidies and revenue offsets available to help reduce the sponsor's hard-dollar plan costs."

"We use revenue sharing to help craft a total solution that takes risk-adjusted performance, price and service expectations into consideration. Our clients are presented their costs – both hard-dollar and soft."

UBOC's efforts go beyond defined contribution plans only. They also offer a bundled solution for employers with defined contribution/401(k), defined benefit and deferred compensation plans, with expense offsets available to help control total plan costs.

Industry Insights

Objective advice One investment advisor has found it relatively easy to extract additional value for firm clients. Zenith Capital, LLC of Santa Rosa, CA, is a fee-based investment advisory and asset management firm. It provides support to both high-net worth individuals and corporate retirement plans, which represent over \$500 million of the firm's client capital base. According to Rick Tasker, the firm's president:

"Most employers, even sophisticated, middle market companies, don't have the information, skills, tools or time to fully understand and manage the expense/revenue realities of their 401(k) plans. Our clients typically save a third or more of their total costs (including asset-based fees) when we help them to aggressively manage the total economic benefit of the vendor/plan relationship."

"There is no such thing as a free lunch but at least you can find out the price before you get the check."

"Total economic benefit" is the term Zenith uses to describe vendor revenues (asset-based and hard-dollar fees) balanced by the service burden that vendors must bear in delivering services to the employer, the plan, its participants and even non-participating employees.

Who ya gonna call? Walker MacRae, LLC is a 401(k) service provider that delivers mutual fund trading and revenue accounting support to plan sponsors. Acting as a "traffic cop," the firm offers access to any mutual fund and many non-mutual fund investment vehicles. TranSend makes it possible for retirement plans to account for and control all revenues generated by plan assets. Said J. Lake Killgore, Chief Operating Officer of the firm:

"We think of ourselves as the good guys in the white hats. Any revenue sharing on client assets is deposited to a separate, plan-specific clearing account. That money is then available for payment of recordkeeping, administration, trust and participant service costs as negotiated with the plan's other service providers. Every penny is accounted for and under the direct control of the plan trustees."

Under this model, the plan can use any third party administrator or service firm and sponsors have complete flexibility in fund selection and financial management of the plan.

"One exciting benefit of this model is the fact that any clearing account balances left over after paying all vendors are then available to the plan for allocation to the trust."

Knowledge works From the consulting world, Milliman, USA supports solutions for medium and large plan sponsors, as an international professional service organization with regional consulting hubs to meet a broad range of benefits and compensation issues. Expense offsets are critical in their delivery of services. Mark Trieb is a principal in Milliman's Dallas office and oversees its employee benefits practice. He notes:

"In our market, one of sophisticated and relatively large plans, service pricing is under pressure through increased disclosure of "soft" revenue sources to vendors and buyer preference for sound economic relationships with their vendors."

"Employers are asking suppliers for more efficient pricing, resulting in greater value for plans and their participants. With our clients, revenue sharing, expense subsidies and rebates are all "on the table" as we work together to help them discharge their fiduciary obligation to act in the best interests of their employee/investors."

Industry Insights

New ball game Persumma Financial is a full-service 401(k) provider and member of the MassMutual Financial Group. In its offerings, Persumma Financial decouples administration fees from investment management fees, capping administrative costs so that participants can invest more of their savings for retirement. Stated Spencer Williams, CEO, Persumma Financial:

“The practice of revenue sharing is neither inherently good nor bad, it’s just one of many ways to price and pay for 401(k) plans. The larger issue is that most participants continue to operate under the false notion that their 401(k) is free. That’s a myth.”

In Persumma’s view the amount a participant pays for his 401(k) depends on two things: the deal his company negotiates with the company’s 401(k) provider and the amount he has in his account. In most cases, for every new dollar a participant adds to their account, a portion of that dollar goes to pay for service – often without the participant’s understanding. And because the price is asset-based, as the participant’s account balance goes up, his or her fees go up – even though the level of service remains the same. Continued Williams:

“With asset-based pricing, the more you save, the more you pay.”

“I believe a fully-disclosed, flat-fee pricing method is better for everyone involved. The sponsor can be assured that servicing costs remain capped and competitive both at the time they make their buying decision and in the future. And the participant knows that as their account balances go up, their administrative fees remain the same. With flat-fee pricing, the more you save, the more you keep.”

This approach by a well-established, diversified service provider could be considered somewhat revolutionary. Speaking for MassMutual, Tom Johnson, Senior VP, Marketing, MassMutual Retirement Services stated that:

“MassMutual’s goal is to give both the sponsor and participant a clearer understanding of how their plans work.”

“By introducing an alternative pricing model, MassMutual brings more options to sponsors, better prospects to participants, and increased competition to the market.”

“Ultimately, sponsors get to choose between revenue sharing pricing that is fair to them and their participants and flat fee pricing from Persumma. Each has its own advantages.”

Consultant view West Coast - In San Francisco, Jon Chambers and his firm, Schultz, Collins, Lawson, Young & Chambers, serves plan sponsors as an advisor on investment and administration issues. He notes:

“Plan sponsors are selecting vendors based on whistles and bells, not participant-paid fees. Several years ago, a web-based survey found that the majority of 401(k) plan participants would choose lower fees over more whistles and bells.”

The firm’s consulting practice addresses the “inside view” of vendor practices.

“Many vendors’ primary focus is maximizing revenue from alliance partner funds. Participants’ risk-adjusted performance (net of asset-based expenses) is generally a much lower priority.”

Consultant view East Coast - Brian Ternoey is the Investment Practice Leader for Curcio Webb, LLC based in Princeton, NY. His firm provides a broad range of fee-based advisory services to a diverse population of corporate clients. In general, he finds that:

“Most plan sponsors and participants don’t understand fees from the investment community. It is clear to us that they don’t know how much they are paying their providers.”

“We would like to see plans encourage greater accumulation of assets – both through retention of terminated employees and at the beginning of employment through immediate plan eligibility.”

Industry Insights

Full disclosure Invesmart, Inc. is a national retirement service provider that draws upon many different fund families for investment services. The firm designs, installs and administers 401(k), defined benefit and non-qualified deferred compensation plans. In managing the client relationship, Invesmart provides full disclosure of revenues received from fund families on behalf of its clients. According to Charley Kennedy, VP Institutional Services at the Pittsburgh based firm:

"Invesmart believes in fully disclosing all plan costs, including mutual fund revenue sharing. Our value proposition includes national coverage through regionally based administration centers, and in every case, the client's service costs are driven by fundamental variables that determine our service burden and fees. We typically see a 10 to 40 basis point revenue sharing offset for our iDirect™ and iAdvise service clients."

The firm provides a flexible pricing schedule that uses a combination of per participant and asset-based fees that can be adapted to meet the needs of any client cost allocation policy.

"We educate the plan sponsor on the total cost of the retirement program including the expense ratio of the funds net of any revenue passed along to Invesmart either as a retirement service provider or to our captive broker dealer, Invesmart Securities."

An unnamed source Speaking off the record, one senior manager from a major fund group is troubled by the current rash of "free" 401(k) e-search services.

"They come to us expecting to be paid from revenue sharing for the privilege of inclusion on their database."

Further, he questions the legitimacy of some financial relationships in the "space":

"I am uncomfortable with this 'pay for play' approach by organizations which offer no recurring plan services, no shareholder services and no investment services."

DC legal view Groom Law Group specializes in employee benefits issues, including regulation and legislation. Located in Washington, DC, it is known as the largest employee benefits practice under one roof in the United States, providing clients with access to nearly 40 lawyers with specialized knowledge.

Of particular interest are elements of the recent Gramm-Leach-Bliley privacy legislation and its effect or potential effect upon banks, third-party administrators and others serving retirement plans and their participants.

While it is a complicated area, Groom lawyer Roberta Ufford has several observations that relate to revenue sharing and sources of compensation, with an eye to the interests of The Securities and Exchange Commission (SEC):

"Finder's Fees and 12b-1s are the kind of 'salesman's stake' that the SEC may believe triggers the obligation to register as a broker."

"The SEC would assert that they have regulatory authority over all securities transactions."

"The SEC's sense of transaction-related compensation is very broad; they have a fairly expansive model."

"TPAs should understand that there is a risk that they may be required to register as a broker if they are taking something that has the appearance of transaction-related compensation; the way the SEC has defined transaction-related compensation, you need to look at it carefully."

"Banks are directly impacted by the interim final rules but other entities, such as Web portals and TPAs that heretofore have been unregulated by the SEC, are exposed to risks from the same regulatory concepts that the SEC will now apply to banks."

Industry Insights

Northwest notables Since the early 1960s, Columbia Management Company and its affiliates, Columbia Funds and Columbia Trust Company, have provided investment management services nationwide through separate accounts for institutions, a family of no-load mutual funds, commingled trust funds, retirement plans, and private portfolios for high net worth individuals. With over \$22 billion in assets, Portland, OR-based Columbia is the largest investment manager in the Pacific Northwest and knows quite a bit about investment product delivery. According to Bob Noack, VP, National Marketing Director at Columbia Funds:

"Where we provide investment-only support to defined contribution/401(k), defined benefit and deferred compensation plans, Columbia is an active participant in the revenue-sharing marketplace. Although we view it as a 'must have' in order to realize distribution on third-party service platforms, we simply can't pay what the more expensive platforms charge."

"We work very hard to make sure that shareholders realize value through expense subsidies paid to third-party service providers. We encourage disclosure of all such transfers."

In its own bundled retirement product, Columbia MasterPlan™, the firm allocates revenues from their own and partner funds to reduce the cost of plan services.

"We document and disclose those transfers in great detail and will structure our client's costs to directly reflect their desire to allocate expenses at the employer, plan or participant level. For example, if a client chooses a fund that pays more than we need (25 bp), we ask them where to allocate the overage: we believe those are plan assets."

Trust tales Trustar Retirement Services grew from the 1997 merger between Delaware Charter Guarantee & Trust Company and Trust Consultants, Inc. An independent subsidiary of the Principal Financial Group®, Trustar provides support to employers through its distribution partners: banks, mutual fund companies, brokerage firms, insurance companies, and registered investment advisors.

Trustar serves as non-discretionary (directed) trustee for clients' retirement plans. As such, it practices full disclosure of fees charged to clients. Prior to 1998 decisions by the DoL (regarding Aetna and Frost Bank), Trustar did not accept revenue sharing – believing that as a trustee, it was prohibited from accepting these kinds of fees. Stated Michael Spencer, VP Sales for Trustar:

"We now accept revenue sharing in the form of shareholder servicing fees collecting these fees from mutual fund companies we trade with. This covers the cost for us to execute transactions on behalf of plan participants. To do so requires us to hold participant accounts on our recordkeeping system and plan level accounts at the mutual fund – saving the fund company the expense of holding participant accounts on their system. We look to revenue sharing to cover our costs and to provide a modest profit – then we reduce explicit plan sponsor fees with any remaining balance. Everything we do is fully disclosed up front to the plan sponsor."

About the Sponsors

McHenry Consulting GroupSM

Founded in 1998, McHenry is a leading provider of comprehensive business strategy services to financial institutions, including mutual funds, investment advisors, asset managers, brokers and insurance companies, as well as plan sponsors.

For both employers and financial institutions, McHenry serves as a force multiplier in creation of strategic relationships that maximize our clients' core competencies. For more information, call 1-800-638-8121 or media@mchenryconsulting.com.

PlanToolsSM

This new resource is a joint venture of McHenry Consulting GroupSM and abeldoc, a new media design and technology firm serving the financial services industry. The PlanToolsSM website, www.PlanTools.com is a free access point for plan sponsors seeking information, tools and skills in the search for better investment-based corporate benefits programs.

Examples of support provided by PlanTools (without cost) will include help for basic employer/plan sponsor risk management policies that can help to address the items listed above, including the PlanTools IPS software tool to create and maintain an investment policy statement that addresses revenue sharing at the plan level. PlanTools IPS is available free of charge, by download from www.PlanTools.com.

Our public website, PlanTools.com is a free service to plan sponsors. It is our way of gathering and sharing information about issues that face employers, plan sponsors and participants in the challenging world of employee benefits. The site maintains a strict privacy policy and we do not collect or share site visitor information.

PlanTools will provide a safe and convenient place for plan sponsors and their advisors to obtain accurate, timely and relatively unbiased information about emerging trends and ways to "greet the future" successfully.

Action Items

There are some important things that plan sponsors can do to better equip themselves – to become better buyers.

The 401(k) movement is critically important to the retirement security of many American workers. Excess fees and mis-allocated costs are a potential threat to the financial security of those workers and to the public's trust in this important retirement funding vehicle.

Following are six specific and easy steps that plan sponsors can take to become more knowledgeable and informed about 401(k) pricing and revenue sharing:

1. Create, implement and maintain an investment policy statement (IPS) that addresses fund expense factors and revenue sharing.
2. Identify the true cost of plan services and the costs borne by employer, plan and participant.
3. Secure improved financial disclosure from plan service providers, including consultants and investment advisors.
4. Understand and document actual, hard dollar costs of your plan services, as well as expenses as a percentage of assets.
5. Benchmark plan costs against fellow employers in comparable peer groups.
6. Keep track of recent news on these issues and to find out what others are saying.

Revenue sharing has helped to create the success of 401(k). Millions of American workers and retirees depend upon this form of defined contribution plan.

Perhaps now is the time for employers, employees, service providers and all participants to come together to find a way to address the question:

'Whose Money is It?'

For *free updates* on the status of the revenue sharing debate, including action by vendors, plan sponsors, regulators, legislators and the courts, send an *email to* contact@PlanTools.com and you will be added to our list of interested persons. *No registration is required* and your identity will always be protected.