PAYING YOUR DEFINED CONTRIBUTION RECORDKEEPER FEES

GOSSELIN CONSULTING GROUP
25 Braintree Hill Office Park, Suite 200 | Braintree, Massachusetts 02184
781-930-3301 | www.gosselinconsultinggroup.com

JANUARY 2017

INTRODUCTION

When it comes to paying for recordkeeping fees, Defined Contribution (DC) plan sponsors have two decisions to make:

1. *The collection methodology:* Will the recordkeeper gather their revenue through the plan's investments (revenue share or fund offset) or though a participant account fee?

2. *The fee allocation methodology:* Will the recordkeeping fee be charged to each participant equally, based on their account balance, or based on their investment choice?

These decisions assume that the plan sponsor does not pay for these fees (which rarely happens).

It is critical for DC Retirement Committees to understand the fiduciary and participant implications of each choice and execute appropriately. Many plan sponsors, knowingly or unknowingly, have been defaulted into their payment methodologies either by their recordkeeper or advisor / consultant. In many cases, sponsors may face unnecessary fiduciary liability exposure when their *fee allocation methodology* creates participant subsidization, especially when based on investment choice.

PARTICIPANT SUBSIDIZATION

In terms of recordkeeping, subsidization is the practice of a participant paying for some or all of the administration fees (in dollar terms) of another participant in the same plan. As all participants generally receive the same recordkeeping services, it can be argued that each participant should pay the same dollar ($) fee.

Subsidization occurs when the fee allocation methodology is based on investment choice and/or account balance rather than the level of services received. In a plan utilizing one or both of these payment practices, participants investing in higher revenue sharing options and/or with larger account balances (both relative to others in the plan) are subsidizing the recordkeeping costs of participants investing in lower revenue sharing options and/or with smaller account balances. This has a direct impact on relative participant account balances in the plan.

Although commonplace, participant subsidization can be considered an inequitable way to allocate recordkeeping costs, as all participants generally receive the same level of services yet there exists a wide (relative) variance across individual costs.

Let's now take a closer look at the two kinds of participant subsidization.

INVESTMENT CHOICE Subsidization

Of most concern to plan sponsors should be investment choice subsidization. If your plan utilizes revenue share (from the plan's investment options) to pay for recordkeeping services and the level varies by fund option, investment choice subsidization exists.

In this model, participants pay recordkeeping fees, in dollar terms, based on their investment allocation and the revenue share (% or bps) built into each fund option's expense ratio; note that participant account balance also plays a role but that will be discussed in the following section.

Table 1.0 (below) illustrates an example of pure investment choice subsidization. Four plan participants (1 - 4) with the same account balance ($50,000) invest in various funds (A - D). Each fund's expense ratio is structured with varying levels of revenue share (0.00% to 0.50%).

Table 1.0

Participants	Fund Option	Account Balance	Revenue Share	Annual Participant RK Fees [1]
-	-	a	b	a x b = c
Participant 1	Fund A	$ 50,000	0.40%	$ 200.00
Participant 2	Fund B	$ 50,000	0.10%	$ 50.00
Participant 3	Fund C	$ 50,000	0.50%	$ 250.00
Participant 4	Fund D	$ 50,000	0.00%	$ 0.00

[1] Annual Recordkeeper Fee = Participant Account Balance x Revenue Share

The resulting annual recordkeeping fees (account balance x revenue share) range from $0 - $250, which is clearly not equitable considering all participants receive the same level of service. At the extreme, note that Participant 3's account balance is decreased by $250 while Participant 4's does not change.

To amplify concerns, now consider these additional scenarios:

1. *Share Class Selection:* What if a share class exists for Fund C with 0.00% revenue share and Fund D with 0.50%? Since these were not utilized, it could appear that the plan sponsor has knowingly chosen for Fund C investors to subsidize Fund D investors.

2. *Auto-Enrollment Scenario:* What if the plan's default option (i.e. target date funds) has the highest revenue share? Sponsors are purposely having defaulted participants subsidize those who allocate on their own.

3. *Capital Preservation Scenario:* What if this option has the highest revenue share? Sponsors are having participants in the typically lowest returning plan investment, who are seeking to preserve their capital, subsidize those in typically higher returning funds.

Please also note that this fee allocation methodology typically lacks participant transparency. In most cases, participants are not aware of each fund's specific revenue share amount. The fee disclosure requirement is to simply notify participants that a portion of one or more of the plan's fund expense ratios may be allocated to the recordkeeper to cover plan administration costs.

Plan sponsors should not knowingly choose to allocate (and pay for) their recordkeeping fees based on a participant's investment choice.

ACCOUNT BALANCE Subsidization

In a pure account balance subsidization model, participants pay recordkeeping fees, in dollar terms, based simply on their account balance. Unlike investment choice subsidization where varying percentages / fees were charged against account balances (based on participant investment allocation / fund revenue share), here the percentage is a constant across the plan and its participants.

Typically, revenue is collected through an account charge but can, in select situations, be applied through the plan's investments. For this discussion, we will consider the account charge scenario only as the plan investment scenario typically requires higher fees driven by unitization services.

Table 2.0 (below) illustrates an example of pure account balance subsidization. Four plan participants (1 - 4) with various account balances ($10,000 - $100,000) are each charged 0.25% for recordkeeping services.

Table 2.0

Participants	Account Balance	Account Charge	Annual Participant RK Fees [1]
-	a	b	a x b = c
Participant 1	$ 10,000	0.25%	$ 25.00
Participant 2	$ 25,000	0.25%	$ 62.50
Participant 3	$ 50,000	0.25%	$ 125.00
Participant 4	$ 100,000	0.25%	$ 250.00

[1] Annual Recordkeeper Fee = Participant Account Balance x Account Charge

The resulting annual recordkeeping fees (account balance x account charge) range from $25 - $250, all based on the specific participant's account balance.

While clearly not equitable, this payment methodology is somewhat similar to the US tax system – where citizens with larger taxable income pay higher taxes, in dollar terms, than those with lower taxable income, despite generally receiving the same services. In fact, the US tax code takes this concept one step further, as the tax rate (%) increases as one's taxable income base expands (referred to as a progressive tax/fee). As such, one could argue that account balance subsidization is an appropriate recordkeeping fee allocation methodology.

It's also worth noting that this fee allocation methodology, when applied through a participant account charge, is fully transparent to the participant as a line item on their statement.

Finally, consider that recordkeeping fees are being collected independent from the plan's investments. As revenue share is therefore not required, a plan can offer the lowest cost vehicle and share class for each of their investments. This improves participant return and also allows the Retirement Committee to more fairly evaluate each investment's return. Remember that revenue share impairs a fund's performance even though it has nothing to do with a fund's operations or investment management. Revenue share can severely impact a fund's performance and rankings, especially in low return asset classes such as fixed income.

AVOIDING PARTICIPANT SUBSIDIZATION
Equally allocate recordkeeping fees across participant base

Minimizing, or preferably, eliminating participant subsidization can be accomplished by equally distributing, in dollar terms, the cost of recordkeeping across the participant base. In nearly all cases, revenue is collected through a participant account charge.

Table 3.0 (below) illustrates an example of equitably allocating recordkeeping fees. Each of the four participants is charged $125 regardless of their account balance or investment choice.

Table 3.0

Participants	Annual Participant RK Fees [1]
Participant 1	$ 125.00
Participant 2	$ 125.00
Participant 3	$ 125.00
Participant 4	$ 125.00

[1] Annual Recordkeeper Fee = same for each participant

There is clearly a case for this fee allocation methodology as participants within the same plan generally have access to and receive the same suite of ongoing recordkeeping services.

As is the case with account balance subsidization, this payment methodology has the advantages of being fully transparent to the participant and allows for the use of the lowest cost vehicles and share classes (for each investment).

At Gosselin Consulting Group, we believe this equally distributed fee allocation methodology, collected as a participant account charge ($), is the appropriate recordkeeping fee payment strategy for most plans. This strategy truly allocates the recordkeeping costs fairly across the participant base, minimizes or eliminates participant subsidization, provides participants with full fee transparency, improves investment returns, and allows for more effective performance monitoring.

Ultimately, we believe this strategy puts the plan sponsor in the best fiduciary position and treats plan participants in the most fair manner.

What if the plan sponsor can't eliminate all revenue share?

It can be still challenging to eliminate all revenue share. Sometimes even the lowest cost investment vehicle and/or share class, for an appropriate fund, may still include a minimal amount of revenue share, ranging from 0.05% to 0.15% for example. This shouldn't, however, prevent a plan sponsor from doing their best to minimize subsidization (revenue share) by moving to the lowest cost investment vehicle and/or share class for each of their investments. In cases where revenue share remains, plan sponsors should document their research and the lack of an available non-revenue sharing vehicle and/or share class (for the selected investment manager).

Fortunately, more and more investment managers continue to launch new investment vehicles (collective trust) and/or share classes (i.e. R6, Instl) with 0.00% revenue share as industry trends move away from this type of remuneration. It is critical for the Retirement Committee to evaluate all available investment vehicles and share classes (on an ongoing basis) for each of their investment strategies offered in the plan.

In cases where revenue share still remains, a plan sponsor still may have the option to truly eliminate subsidization. Many recordkeepers now have (or are developing) the ability to proportionally credit revenue share back to the actual participant who paid it (based on their fund choice) according to their exact amount paid for a given period (i.e. quarter).

Let's revisit Participant 2 from the investment subsidization example (see Table 1.0 or 4.0 below) but now assume recordkeeping services are fully paid through an equally distributed participant account charge ($125 as example). We'll also assume that the lowest cost investment vehicle and share class available for Fund B still has the 0.10% revenue share.

Table 4.0

Participants	Account Charge RK Fees [1]	Fund Option	Account Balance	Revenue Share	Revenue Share RK Fees [2]	Total Participant Annual RK Fees [3]
-	a	-	b	c	b x c = d	a + d = e
Participant 2	$ 125.00	Fund B	$ 50,000	0.10%	$ 50.00	$ 175.00

[1] Annual Recordkeeper Fee = same for each participant
[2] Annual Recordkeeper Fee = Participant Account Balance x Account Charge
[3] Total Annual Recordkeeper Fee = Account Charge + Revenue Share

In this scenario, Participant 2 incurs an account charge of $125 annually but still incurs an additional $50 fee due to revenue share. To eliminate the extra $50, the plan sponsor could decide to have the recordkeeper return that $50 to the participant, for example as a $12.50 refund on a quarterly basis.

As previously mentioned, returning revenue share to the participants who paid it is a recently implemented or upcoming functionality enhancement for most recordkeepers. As such, Retirement Committees should evaluate their recordkeeper's current payback methodology and operational functionality, along with any potential future enhancements, to determine their plan's most appropriate course of action.

Finally, please note that the lowest cost vehicle and/or share class for a particular manager may not be the lowest from a "net investment" cost perspective (total expense ratio minus revenue share). When implementing revenue share reimbursement, total costs (after reimbursement) may actually be lower by using a vehicle and/or share class with a higher total expense ratio. Retirement Committees should always evaluate the net investment cost of each available vehicle and share class to determine the most appropriate option. *For more information on this subject, please see Gosselin Consulting Group's DC strategy paper on "Net Investment Costs"*.

How does a plan sponsor implement an equally distributed participant account payment methodology if the plan is priced as a percentage of assets?

In conjunction with choosing a "payment" strategy, plan sponsors must also choose a recordkeeping "pricing" strategy (calculation methodology) most appropriate for their plan. In other words, should recordkeeping costs be calculated as a percentage of assets (x bps), as a fixed-dollar per-participant structure ($x per-participant), or in some other manner?

At Gosselin Consulting Group, we believe pricing recordkeeping services in a fixed-dollar per-participant manner is the most appropriate strategy as it directly links costs to services (not assets) and prevents fees from rising as asset levels increase. *For more detailed information on this subject, please see Gosselin Consulting Group's strategy paper on "Pricing Your DC Plan"*.

The fixed-dollar per-participant pricing strategy is also simple to translate into an equally distributed payment methodology. For example, if a plan's annual recordkeeping services are priced at $125 per-participant, each participant can be charged $125 annually.

If recordkeeping services are priced as a percentage of plan assets (x% or bps), however, the sponsor can still use an equally distributed payment methodology. In this scenario, the plan sponsor could ask the recordkeeper to calculate total plan fees (x% times plan assets) annually (or quarterly), divide that figure by total plan participants, and charge as an account fee. The drawback, of course, in this model is that the participant account charge will vary from year-to-year (or quarter-to-quarter).

THE LONG-TERM IMPACT OF PARTICIPANT SUBSIDIZATION

The concept of revenue sharing is often discussed on an annual period and is typically presented in basis points. For some, this unfortunately de-emphasizes the dollar impact of annual and working career lifetime subsidization on relative participant account balances within a plan.

As we have already illustrated examples of annual subsidization (in dollar terms), let's now consider the impact during a participant's entire working career.

Subsidization amounts between employees over their careers will be driven by many factors including investment choice, share class structure, salary and deferral rates. The potential participant subsidization combinations are seemingly endless.

As one example only, Table 5.0 (above right) illustrates career subsidization issues driven solely by investment choice share class structure. Three participants, all in the same plan, start their careers on their 22nd birthday. Each participant:

1. receives a 3% annual salary increase over their lifetime
2. contributes 7% annually over their working lifetime
3. invests in a unique fund (from the other), each with a career annualized return of 7%, on a gross of fees basis, and each with various expense ratio / revenue share structures

Table 5.0

CAREER PARTICIPANT SUBSIDIZATION EXAMPLE	Participant 1	Participant 2	Participant 3
STARTING SALARY (at age 22)	$30,000	$30,000	$30,000
SALARY INCREASE (annually)	3%	3%	3%
CONTRIBUTION RATE (annually)	7%	7%	7%
FUND CHOICE	**A**	B	**C**
PORTFOLIO RETURN (annual gross of fees)	7%	7%	7%
PROSPECTUS EXPENSE RATIO (net)	0.50%	0.75%	1.00%
REVENUE SHARE	**0.00%**	0.25%	**0.50%**
PORTFOLIO RETURN (annual net of fees)	6.50%	6.25%	6.00%
ACCOUNT BALANCE (on their 65th birthday)	$708,304	$665,805	$626,256
ACCOUNT BALANCE (on their 70th birthday)	**$1,016,990**	$947,825	**$884,063**
CAREER RECORDKEEPING FEES (by their 65th birthday)	$0	$21,335	$40,798
CAREER RECORDKEEPING FEES (by their 70th birthday)	**$0**	$31,781	**$60,358**

Deferral amounts ($), based on salary / contribution rates, remain under current maximum threshold throughout

The results…

For evaluation purposes, we calculate each participant's ending account balance and working career lifetime recordkeeping fees on their / by their 65th and 70th birthdays. The results clearly illustrate the long-term issues associated with participant subsidization.

At age 70, Participant 3's account balance is $884,063 yet Participant 1's is 15% higher at $1,016,990. As a result of investing in Fund A (no revenue share or 0.00%), Participant 1 has paid no recordkeeping fees (0.00%) during their career. Meanwhile Participant 3 has incurred $60,358 in recordkeeping fees because he invested in Fund C with 0.50% revenue share. The recordkeeping fees, along with the lack of return compounding on them, has cost Participant 3 $132,927 vs. Participant 1 (account balance difference). As a reminder, this occurred despite each participant investing in a fund with the same gross of fees return.

ARE THERE RULES FOR PAYING RECORDKEEPING FEES?

While the Department of Labor (DOL) does not mandate or recommend a particular recordkeeping payment strategy, portions of Rule 408(b)(2) and general ERISA fiduciary standards suggest that a transparent equally weighted participant account charge ($) would comply with industry best practices if applied at the participant level.

According to Rule 408(b)(2), plan sponsors can only enter into a service arrangement if fee arrangements and compensation for services are reasonable.

If applied at the participant level (vs. plan), fee arrangements and compensation for recordkeeping services should be reasonable for each individual.

Considering participants in a plan generally have access to the same set of recordkeeping services, those paying fees higher than the plan's average participant (total plan administration costs divided by number of participants) could consider their fees unreasonable (whether it be through investment choice or account balance subsidization).

According to ERISA fiduciary standards, plan sponsors are required to act prudently and solely in the best interest of the plan's participants and beneficiaries.

If applied at the participant level (vs. plan), one could surmise that the plan sponsor is not acting in the best interest of those participants paying higher recordkeeping fees (vs. plan average).

DEVELOPING (AND IMPLEMENTING) A RETIREMENT COMMITTEE DECISION PROCESS

If no specific rules apply, we should remember that ERISA is more about process than performance. Every DC Retirement Committee should have a process in place to choose the most appropriate recordkeeping fee collection and allocation methodology for their plan.

As one strategy to initiate the discussion, we believe plan sponsors should assess their views on participant fee allocation, participant fee transparency, and investment vehicles / share classes to develop a policy that is fair, justified, and transparent. We illustrate these assessment questions and potential responses below.

1) Recordkeeping Fee Allocation: Should participants pay

A) equally (in dollar terms)?
B) based on their account balance?
C) based on their investment allocation and account balance?

2) Recordkeeping Fee Transparency: Should participants

A) be provided with full transparency?
B) partial transparency?
C) no transparency?

3) Investment Vehicles / Share Classes: Should manager performance be evaluated

A) net of investment management and operational fees?
B) net of investment management and operational fees and revenue share?

We believe most plan sponsors will answer (A) to each question above – ultimately minimizing plan sponsor fiduciary liability exposure while treating their participants in the most fair manner possible.

SUMMARY

This paper is meant to illustrate how a plan's recordkeeping payment strategy can impact its participant's administration fees and account balances. Participant subsidization, if it exists, can create unnecessary fiduciary liability exposure, especially when based on investment choice, and may be considered unfair and/or inequitable. Plan sponsors should evaluate their recordkeeping payment collection and allocation methodology on a periodic basis to be sure they are utilizing the most appropriate strategy for their plan.

At Gosselin Consulting Group, we believe an equally distributed fee allocation methodology, collected as participant account charge ($), is the appropriate recordkeeping payment strategy for most plans. This strategy fairly distributes the recordkeeping costs across the participant base, minimizes or eliminates participant subsidization, provides participants with full fee transparency, improves investment returns, and allows for more effective performance monitoring. Ultimately, we believe this allows the plan sponsor to best position themselves as a fiduciary while treating their participants in a fair and equitable fashion.