



## Drawing a Bead on Cost

**A clearer picture of 401(k) plan fees is helping more plan providers drive down costs.**

[Randy Myers](#), CFO Magazine

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A small but growing band of employers is fueling a rebellion against long-opaque cost structures in the 401(k) plan market. Working with pension consultants to ferret out esoteric expenses, these plan sponsors are dissecting fee arrangements. Where the assets at stake are big enough to provide negotiating leverage, the sponsors are squeezing vendors for more-attractive deals.

The benefits can be enormous. A worker who socks away \$10,000 a year for 30 years and nets 8 percent annually could retire with an additional \$109,000 if her plan found a way to pay 50 basis points less in operating expenses. Those types of savings are within reach of plans that are saddled with high-cost investment options.

Employers have always had a fiduciary duty to make sure their retirement-savings plans are paying reasonable fees, but that responsibility has often been difficult to fulfill. Vendors generally don't reveal the true cost of their products when pitching them. Sometimes sponsors don't understand the cost structure behind vendor pricing and so remain blind to opportunities to trim fat. While many plan providers now disclose costs more clearly than they did a few years ago, the pricing waters are still murky throughout much of the industry.

In the past, such obscurity might have helped to head off potential complaints about fiduciary liability, but pressure is building on companies to focus on this issue. After investigating compensation practices in the defined-contribution-plan marketplace, the Securities and Exchange Commission recently warned sponsors about conflicts of interest within the system. Meanwhile, the Department of Labor, which oversees the Employee Retirement Income Security Act (ERISA), is encouraging sponsors to do more to rein in fees.

Also, an increasing number of smaller retirement-plan providers operate on a so-called open-architecture framework, which gives plans access to funds from multiple investment managers and clearly lays out the costs for each one. If these providers can sweep aside the cost curtain, sponsors reason, then the big banks, brokers, insurers, and mutual fund companies that dominate the 401(k) plan business should be able to as well. Much more money is at stake, as the value of assets in 401(k)s and other defined-contribution plans has mushroomed, from \$1.4 trillion in 1994 to \$3.2 trillion 10 years later.

Shirking fiduciary responsibility in this arena is especially risky for any executives who serve on companies' retirement-plan committees. With more workers relying on defined-contribution plans for retirement, failure to ensure that plans operate as efficiently as possible is increasingly likely to spawn lawsuits. The penalties for fiduciaries could be high, as their personal liability equals the value of the assets in their plans. "It's going to be the next big wave of litigation," suggests Washington, D.C.-based ERISA attorney Sherwin Kaplan, counsel to the law firm of Thelen Reid & Priest LLP. Kaplan says a fiduciary should be aware of all sources of payments made to a service provider in connection with the plan (see "Under Fire" at the end of this article).

### Quantifying the Savings

Among those companies whose awareness has been raised is Atlanta-based Internet Security Systems Inc. About two years ago, the company asked its financial adviser, White Horse Advisors LLC of Atlanta, to evaluate what ISS was paying vendors to run its \$27 million 401(k) plan. Although ISS found its costs to be in line with market rates, Daniel Eidson, the company's director of treasury, says the exercise triggered a fresh assessment of pricing policy by its plan provider, which promptly lowered the plan's asset-based fees by a couple of basis points. ISS also discovered that it was paying administrative fees on a number of dormant accounts that it was able to eliminate by cashing out some of those account owners and convincing others to roll their assets into another retirement account somewhere else.

ISS is hardly alone. Matthew Hutcheson, a pension consultant who hires himself out to retirement plans as an independent fiduciary, says that after a lull in 2005, he had more fee-auditing assignments in the first three months of 2006 than he did all of last year.

Many employers have reaped larger savings than ISS. A Chicago-based telecommunications company recently hired consulting firm Blue Prairie Group LLC to help it find a new retirement-plan provider and lower its 401(k)

costs. After steering the company to an open-architecture provider offering a lower-cost and more broadly diversified investment menu, Blue Prairie helped the company negotiate a contract in which any "excess" revenue reaped by its new provider will be returned to the plan.

The redesign shrunk the investment-management cost of the plan to 60 basis points, down from 71, says Blue Prairie managing director Matthew Gnabasik. Meanwhile, any administrative revenues the provider earns in excess of 15 basis points of plan assets will be returned to plan participants, either in the form of lower-cost funds or share classes, or as a credit against eligible ERISA plan expenses.

### **Fee-for-All**

Revenue-recapture arrangements like this are made possible largely by the complex, asset-based fee structure that providers have adopted and the curious economics of retirement-plan management. Broadly speaking, retirement plans incur two kinds of fees, one for administrative services and one for investment management. Administrative fees, which cover recordkeeping and other sundry mechanicals, are usually calculated on a per-participant basis and can be paid either by the employer or the plan itself. They're typically quite modest — perhaps \$100 or so per participant per year.

Investment-management fees are based on a percentage of plan assets and are levied by the mutual fund companies or other money managers that provide investment options. These fees are usually far larger than administrative fees and are always paid by the plan itself, meaning, ultimately, plan participants.

Behind the scenes, a lot of money moves around through various revenue-sharing arrangements between fund companies, money managers, and the various brokers, investment advisers, third-party administrators, custodians, and consultants that package, sell, or service plans. Often these behind-the-scenes transfers are invisible to plan sponsors. They take various forms: one-time finder's fees or annual 12b-1 marketing fees paid by fund companies to brokers and investment advisers to steer business their way, subagent transfer fees paid to third-party recordkeepers, and "shareholder-servicing fees" paid to vendors providing services to the plan. Identifying these fees is often difficult, especially for plans administered by insurance companies, since those are structured as variable annuities in which the various costs are typically aggregated into a single, opaque "wrap" fee.

In practice, financial-services firms earn so much money from investment-management fees that, except for the smallest plans, they can afford to underwrite the administrative fees. That allows them, or third-party administrators, to offer employers "free" retirement plans. It sounds like a sweet deal, but there's a rub. Fueled by stock market price increases and the steady influx of cash from participant contributions, the assets in a retirement savings plan often grow disproportionately faster than the number of participants in the plan and the cost of servicing them. Ultimately, that revenue is far beyond what it actually costs to run the plan.

Employers also have an opportunity to negotiate lower fees as their plan's average account balance soars, notes David Wray, president of Chicago-based Profit Sharing/401(k) Council of America, whose members are plan sponsors. Such growth suggests the provider is earning increasingly more asset-based income on the plan relative to the number of accounts it is servicing.

### **Exercising Your Leverage**

The cost of a fee audit may be prohibitive for plans too small to negotiate significant price breaks. For plans with assets of \$1 million to \$50 million, Hutcheson typically charges somewhere between \$10,000 and \$25,000. For plans with \$100 million-plus in assets, the cost is more like \$30,000. The payoff, however, can be dramatic, averaging about \$400,000 annually, says Hutcheson. Gnabasik says his clients' plans — with assets typically between \$20 million and \$500 million — are saving hundreds of thousands, even millions of dollars, over five-years through portfolio redesign and revenue-recapture programs.

Where a fee audit uncovers the opportunity for cost savings, the simplest and most effective way to recover money may be to request access to lower-cost investment options — either a different, lower-cost class of shares of the existing funds, or less-expensive alternatives. If the provider is still reaping excess revenues after a switch to the lowest-cost funds available, Hutcheson says it may be time to set up a revenue-recapture program.

It's not necessary to hire pension consultants to make sense of retirement-plan fees. Hutcheson says sponsors should feel no compunction about asking providers hard questions about costs. But, he adds, be prepared for spin. "I have found that every time I'm asked to perform an audit, it's because someone got an obscure answer to a question," he observes. Sponsors also can ask plan providers to complete the model 401(k) Plan Fee Disclosure Form available on the Department of Labor's Website since 2000. Just don't expect any of this to be easy.

"It's dirty, hard work," says Ward Harris, founder and managing director of McHenry Consulting Group in Emeryville, California, which provides consulting services for financial-services firms. "The ones that do it have to really be on their game, because there are a lot of deals going on out there and there is a lot of obfuscation."

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## **Under Fire**

Behind-the-scenes revenue-sharing arrangements between retirement-plan providers may not only be unreasonable, they may also be illegal. In 2001, in a case not yet settled, the trustees of a 401(k) plan sponsored by Bridgeport, Connecticut-based Flyte Tool & Die Co. filed suit against Nationwide Financial Services Inc. and its Nationwide Life Insurance Co. unit. The trustees argued that Nationwide's retention of revenue-sharing funds linked to its plan constituted both a breach of Nationwide's fiduciary duties and a prohibited transaction under the Employee Retirement Income Security Act (ERISA).

The claim rests in part on an advisory opinion issued in 1997 by the Department of Labor. The department said vendors that are plan fiduciaries and either have discretion over the selection of its investment options or provide advice on selecting those options may not retain such revenue-sharing payments. In this case, the plaintiffs argue, Nationwide did keep them instead of passing them through to the retirement plan as required by the DoL's *Frost* opinion. On March 6 of this year, a federal judge in Connecticut dismissed Nationwide's move for summary judgment in the case. ERISA attorney Sherwin Kaplan says the lawsuit demonstrates that it's not too late for plan sponsors to investigate how their retirement plans' dollars are being spent and, if necessary, take appropriate action. Sponsors should be vigilant in asking questions of their plan providers, he says, and, if good answers aren't forthcoming, they should be prepared to take legal action. "Had these fiduciaries not sued Nationwide," Kaplan observes, "they could have been sued themselves by a plan participant." — *R.M.*