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How You Are Paying What You Don't Know: A Primer on Indirect Mutual Fund Payments

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In the typical 401(k) plan, the participants are bearing all, or almost all, of the cost of the plan through payments made by mutual funds to the plan's providers. Of course, that excludes the cost of a company's profit sharing and matching contributions—which can be significant in their own right. But, when it comes to the fees paid to service providers—like the recordkeeper and the adviser—participants almost always bear the brunt of the cost.

In the 401(k) community, these payments are called "revenue sharing." In the mutual fund world, they have other names . . . shareholder servicing fees, transfer agent fees, and 12b-1 fees. By any name, they come from the money in the participants' 401(k) accounts.

Let's take a look at how that happens.

As a general statement, these types of expenses fall into three categories:

- The first is investment management—typically the fees paid to a mutual fund management company, and its affiliates, for investment management and other services.
- The second is the cost of advice, that is, the payment of 12b-1 fees and other amounts to financial advisers or to registered investment advisers who provide advice and recommendations on the selection and monitoring of investments, among other things.
- The third is the cost of the plan provider or recordkeeper. Most of that expense is paid indirectly through shareholder servicing fees and subtransfer agency fees. Those payments are made from the mutual funds to the plan provider to subsidize services, such as processing the daily transactions in the investments, the maintenance of the account balances, the website and 800 number, and other similar services for plans and participants.

All three have one thing in common . . . they are made from the money in the mutual funds, either directly or indirectly. (While all of the payments are sourced in the mutual funds held in participants' accounts, the actual payment to the service provicers may be from the mutual fund, its management company, its distributor, or other affiliated entity. For ease of reference, this bulletin refers to those entities in the aggregate as the "mutual fund complex.")

To illustrate my points, let's look at the prospectus of a large mutual fund, which is a common holding in 401(k) plans.

First, the prospectus explains that it has different share classes that can be held by retirement plans. Each share class has its own cost structure (because the mutual fund makes payments in varying amounts to different service providers), but all of the share classes are based on the same pool of investments. In other words, the gross investment return is the same for all shareholders in the fund, but the net investment return varies depending on the expense structure of the share class. The prospectus describes those expenses as follows:

Annual fund operating expenses (deducted from fund assets)

	Class R-1	Class R-2	Class R-3	Class R-4	Class R-5
Management fees	*0.27%*	*0.27%*	*0.27%*	*0.27%*	*0.27%*
Distribution and/or service (12b-1) fees	*1.00*	*0.75*	*0.50*	*0.25*	*none*
Other expenses	*0.16*	*0.40*	*0.19*	*0.16*	*0.11*
Total annual fund operating expenses	*1.43*	*1.42*	*0.96*	*0.68*	*0.38*

So, if a plan has the most expensive share class, R-1, the total annual fund operating expenses the participants would be paying is 1.43% per year of their money invested in the mutual fund. However, if a plan has the least expensive share class, the participants would be paying .38% per year, or 1% per year less than the most expensive share class. Compounded over a working career, that 1% differential is substantial.

However, as you can see, the management fees charged by the management company do not vary from share class to share class; they are exactly the same for each. Thus, the difference in expenses must be found in the other two categories and, for the most part, it is in the category entitled "Distribution and/or service (12b-1) fees." In fact, the expenses in that category, from high to low, vary exactly 1% per year. In most cases, those payments are made to broker-dealers, and their brokers—or financial advisers, for services to plan sponsors in the selection and monitoring of plan investments. (Financial advisers may provide other services to plans, such as assistance with plan design, finding the provider for the plan, participant education and enrollment meetings, and so on.)

Thus, if the plan is broker-advised (*i.e.*, if the investments are broker-sold), the compensation to the financial adviser and the broker-dealer could range from 1% per year to .25% per year (sometimes called 100 basis points to 25 basis points). Ordinarily,

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the smallest plans would pay the highest commission rate, while a larger plan would pay a lower commission. The reason the commission rate is higher for small plans is obvious—because a small percentage of a small amount is not enough to adequately compensate a financial adviser for his services. For example, a 50 basis point (or .50%) commission on a $500,000 plan is only $2,500. If the adviser does his job properly—*e.g.*, assists in the selection of a provider, recommends specific mutual funds, helps with the monitoring, provides investment and financial education for participants, and so on—that compensation may be too little rather than too much.

The issue is not whether any of the commission rates are improper, but instead whether the commission structure is appropriate based on the size of the plan and the services to the plan and the participants. For example, for a $5,000,000 plan, the 1% commission share class would be uncommon and likely inappropriately high, but the .25% share class could be a prudent compensation formula.

The fiduciaries have the job of making that decision. Of course, fiduciaries cannot make the decision if they do not know of the particular share class and the related commissions, and if they do not have information needed to determine the relative value of the services, as well as the fees paid for similar plans in the competitive marketplace. Further, fiduciaries have a duty to understand the range of possible payments to the broker-dealer and financial adviser and to evaluate any potential conflicts (for example, is there an incentive for the adviser to recommend a particular share class?). Unfortunately, as a practical matter, most fiduciaries are not, in my experience, aware of the existence of the multiple share classes or about the impact on participants of the selection of a particular share class. (In fact, in some cases fiduciaries may not even know the share class owned by their plan.)

The following schedule, from the prospectus of the same mutual fund, illustrates the impact on participants' benefits of selecting a higher cost share class. Over a 10-year period, a $10,000 investment in the most expensive share class, R-1, would have been charged $1,713. However, an investment in a less expensive share class, R-4, would have been charged about half of that amount, or $847. In other words, on a $10,000 investment, the participant would have earned almost $900 more with the R-4 share class than with the R-1 share class.

> *The examples below are intended to help you compare the cost of investing in the fund with the cost of investing in other mutual funds. The examples assume that you invest $10,000 in the fund for the time periods indicated, that your investment has a 5% return each year, that all dividends and capital gain distributions are reinvested, and that the fund's operating expenses remain the same as shown above. The examples do not reflect the impact of any fee waivers or expense reimbursements. Although your actual costs may be higher or lower, based on these assumptions, your cumulative estimated expenses would be:*

	1 year	3 years	5 years	10 years
Class R-1	146	452	782	1,713
Class R-2	145	449	776	1,702
Class R-3	98	306	531	1,178
Class R-4	69	218	379	847
Class R-5	39	122	213	480

Unfortunately, while participants are typically given information about the expense ratios for the mutual funds included in their plans, they are not given this information about the differences in expense ratios and the impact of those differences, unless they are given the prospectus. As a result, it is hard for participants (and perhaps for some of their advises) to efficiently determine if the plan fiduciaries are prudently doing their jobs.

The next category, "Other expenses," includes a variety of operating expenses paid by mutual funds, such as legal and accounting fees, shareholder servicing fees and transfer agency fees. While, in most cases, those payments are made to affiliates of the mutual fund and the mutual fund management company, in the 401(k) context some of the payments are made to the plan provider (that is, to the recordkeeper or an affiliate of the recordkeeper).

When the recordkeeper is not affiliated with the mutual fund, or its management company, subtransfer agency fees and/or shareholder servicing fees are paid to the unaffiliated recordkeeper—to help subsidize the cost of the services provided by the recordkeeper to the mutual fund shareholders, *i.e.*, to the plans and the participants. (As a definitional matter, if the plan provider, or recordkeeper, is independent of the mutual fund and the mutual fund management company, it is referred to as being "unaffiliated.")

The schedule below, from the same prospectus, identifies the payments from the "Other expenses" category to the unaffiliated entities which, in this case, I take to mean recordkeepers (or similar or related entities). As you can see, the amount of the payment varies depending on the share class. Since these payments are made to the recordkeeper by the mutual fund, they are part of the revenues of the recordkeeper, and fiduciaries have a duty to prudently monitor that revenue to determine whether the recordkeeper is reasonably compensated or is over-compensated. If the recordkeeper is over-compensated, when considering all direct and indirect revenues, the fiduciaries have a duty to address that situation for the benefit of the participants.

> *The "Other expenses" items in the table above include custodial, legal, transfer agent and subtransfer agent/recordkeeping payments, as well as various other expenses. Subtransfer agent/recordkeeping payments may be made to the fund's investment adviser, affiliates of the adviser and unaffiliated third parties for providing recordkeeping and other administrative services to retirement plans invested in the fund in lieu of the transfer agent providing such services. The amount paid for subtransfer agent/recordkeeping services will vary depending on the share class selected and the entity receiving the payments. The table below shows the maximum payments to entities providing services to retirement plans.*

Payments to unaffiliated entities	
Class R-1	.10% of assets
Class R-2	.25% of assets
Class R-3	.15% of assets
Class R-4	.10% of assets
Class R-5	.05% of assets

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In addition to those payments, the mutual fund complex also pays additional compensation to the broker-dealer for broker-sold investments. The payments described below (which come from the mutual fund indirectly, that is, through the management fees, rather than being a direct charge to the investments) are paid to the broker-dealer, but usually are not shared with the financial adviser. While these payments do not represent a direct charge to the participants (because they are sourced in the management fees), basic economics tells us that the management fees would be lower but for charges like this which reduce the compensation of the investment manager.

Even if these payments were not a cost consideration, they would be a conflict of interest which plan fiduciaries need to be aware of and to evaluate. In other words, if the broker-dealer, which supervises the financial adviser, receives additional payments from certain mutual fund complexes, but not from others, does the broker-dealer have an incentive to encourage the financial adviser to sell investments from the higher paying fund families? (Note that the newly proposed regulation under ERISA section 408(b)(2) would require disclosure of this conflict of interest—if it were material. Also, note that the determination of materiality is from the perspective of a reasonable fiduciary—and not from the perspective of the broker-dealer or the mutual fund.)

The prospectus describes these payments as follows:

> *"[An affiliate of the investment manager] at its expense, currently provides additional compensation to investment dealers. These payments may be made . . . to the top 75 dealers (or their affiliates) that have sold shares of the . . . Funds. The level of payments made to a qualifying firm in any given year will vary and in no case would exceed the sum of (a) .10% of the previous year's . . . Funds sales by that dealer and (b) .02% of . . . Funds assets attributable to that dealer. For calendar year 2006, aggregate payments made by . . . to dealers were less than .02% of the assets of the . . . Funds. A number of factors will be considered in determining payments, including the qualifying dealer's sales, assets and redemption rates, and the quality of the dealer's relationship with . . . [the distributor]. . . . makes these payments to help defray the costs incurred by qualifying dealers in connection with efforts to educate financial advisers about the . . . Funds so that they can make recommendations and provide services that are suitable and meet shareholder needs. . . . will, on an annual basis, determine the advisability of continuing these payments. . . . may also pay expenses associated with meetings conducted by dealers outside the top 75 firms to facilitate educating financial advisers and shareholders about the American Funds."*

Unfortunately, that description is of only limited value to fiduciaries. First, I doubt that most fiduciaries, particularly for small- and mid-sized plans, will understand that the "dealer" referred to in the description is the supervisor of the financial adviser who is recommending the mutual funds. Secondly, while the formulas appear to put a cap on the amount that will be paid on account of a particular 401(k) plan, they do not allow fiduciaries to calculate (or even estimate) the payment or to even determine if the broker-dealer for their adviser is receiving such payments. In addition, fiduciaries are not given the information needed to evaluate the totality of the relationship between the mutual fund complex and the broker-dealer and, therefore, to evaluate the degree of the potential conflict.

Conclusions

The point of this article is not that any of these payments are inappropriate or that it would be improper for a fiduciary to invest in this mutual fund. (In fact, in the interest of full disclosure, I invest in it.) Instead, it is that, after having reviewed the total expenses of the mutual fund, the fiduciaries also need to understand which service providers are receiving payments from the mutual fund and to evaluate the reasonableness of those payments, as well as the potential conflicts of interest. All in all, the payments for the broker and broker-dealer to provide advice, recommendations and other services to the plan and its participants are probably money well spent, if the advice materially assists in the initial selection and ongoing monitoring of high quality 401(k) investments (and, hopefully, high participation rates and adequate deferral rates)—and if the payments are not in excess of the reasonable value of that advice. Similarly, the payments of shareholder servicing fees to a provider usually subsidize the reasonable costs of operating a plan. However, in some cases, those payments can be excessive. Fiduciaries have a duty to know that information and to prevent excessive payments from occurring (or, alternatively, to recoup the excessive amounts for the participants, *e.g.*, through expense recapture accounts).

Forewarned is forearmed. Fiduciaries must be aware of these payments and potential conflicts and must evaluate them. ❖