A New Way To Pay

ERISA accounts offer a "new" way of offsetting plan costs

Louis Berney – 06/09/2008

Many advisers have failed to take advantage of a long-standing program in retirement plan regulations that enables some plans to gain a share of any excess revenue earned by their investment funds and use those dollars to pay for plan expenses or allocate the money directly to participants.

Known as the ERISA budget, or ERISA account, the account captures revenue produced by investments that exceed recordkeepers' actual costs. Not all plans will necessarily see an overage in revenue above costs. But, for those that do, the ERISA account offers a way to combat increasing costs. Mark Niziak, New York Life's Managing Director of ERISA consulting services, says the growing popularity of ERISA accounts "is a byproduct of full fee disclosure as fiduciaries become more cognizant of their obligation to understand what is being paid to service providers, both direct and indirect, and determining what is reasonable."

Advisers can play a critical role in making plan sponsors and investment committees aware of the sometimes-significant discrepancy between revenues and costs, and then counsel plan fiduciaries on how to approach that discrepancy. Some people who have advocated that sponsors and advisers take more interest in ERISA accounts predict one benefit that could spring forth is lower-cost investment funds. "The ultimate goal really is to eliminate any excess revenue," says Michael H. Miller[1], Executive Director of Investments for Oppenheimer & Co., "and the way to do that is to get a lower share class." Although changing to a less expensive share class, or another type of investment vehicle like a collective trust, is preferable, if that is not an option, ERISA accounts can be a way to keep tabs on how much revenue is being produced by the plan and use that revenue for other plan services.

The well-informed adviser, therefore, has a big advantage over competitors, because knowledge of the ERISA account playing field can offer considerable value to a 401(k) plan by creating a pool of money that can be used to improve a plan and its services.

How They Work

"Though the ERISA budget has been around for quite a while, very few advisers are aware of it," says Miller. When 401(k) plans invest in mutual funds, they pay administrative fees, often in the form of 12b-1 payments. However, in the defined contribution world, recordkeepers are paid for some of the same administrative fees: distribution costs, call center support, and materials mailings, among other things. Over time, people figured out that double payment was occurring and more money was being taken out for administrative servicing than actually was being spent on it. So, an ERISA account is a way to capture excess revenue taken from investments that is above and beyond what is needed to run the plan administration.

Large plans are the ones most involved with ERISA accounts, not only because they have more savvy fiduciaries who are more informed about the accounts and fee structures, but also because they likely have the most to gain fiscally. With far larger assets, they have been able to build up ERISA accounts appreciably. Mid-size plans now are beginning to see the benefits they can accrue from the ERISA budgets, and they are the ones looking at them most seriously today, experts say. It remains uncertain how small plans will fare. Their assets may never reach the point where enough excess revenue is created to make the budgets economically viable. Adviser Jason Chepenik, Managing Partner of Chepenik Financial of Orlando, says it might make more sense to negotiate for lower investment fund fees rather than set up a small ERISA account, especially because money in the account must be spent, according to regulations.

However, even when it comes to small plans, advisers can play a central role in helping a sponsor decide how to strategize its approach to the ERISA account. "What I would do as an adviser is help them work

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[1] Michael Miller is now the Senior Retirement Plan Consultant at The PFE Group.

with the administrator to determine what revenue-sharing there is, and then help them to determine what the costs are," says Miller. "In many cases, there may not be an excess."

Revenue-Sharing under the Microscope

Fee disclosure will become even more imperative once the Department of Labor's (DoL) proposed regulations on ERISA section 408(b)(2) (see "Second Cite," "Hidden in Plain Sight?" January-February 2008) becomes effective. In the past, there was no mandate for providers to disclose to sponsors the revenues earned on a plan's investment funds. The new regulation will require such disclosure, making it much easier for plan fiduciaries to know of any excess revenues the plan might earn. That, in turn, will make it easier for a plan to know if it can establish an ERISA account. "To the extent that plan sponsors don't know about this currently, this [fee arrangement] information will be available once these regulations are finalized," says David Wray, President of the Profit Sharing/401(k) Council of America.

Yet, the current focus on fee disclosure is not the only factor driving interest in ERISA accounts. The dramatic growth of account balances in 401(k) plans also has played a significant role. Consider a plan with $10 million in total assets that uses 25 basis points of revenue-sharing to pay its recordkeeper—$25,000 annually. If, over time, those same plan assets grew to $100 million, that 25 basis points of revenue-sharing would now produce $250,000 in revenue for the recordkeeper. Yet, the recordkeeper's costs almost certainly would not have grown commensurately.

So, under the ERISA account concept, Fred Reish, Managing Director and Partner at law firm Reish Luftman Reicher & Cohen, says, "A sophisticated plan sponsor [or adviser] would go to the recordkeeper and say, 'Wait a second. We've analyzed the situation, and a reasonable cost for handling our $100 million is $150,000, not $250,000, because the cost of the services did not grow proportionately with the growth in assets.'" If an agreement could be negotiated between the adviser and recordkeeper to reach consensus over such a disparity between cost and revenue, the excess $100,000 then could be applied to the ERISA expense budget of the plan.

While such an idea seems to make perfect sense, few sponsors are sophisticated enough to be aware of the ERISA budget approach for recapturing excess revenues or to know how to calculate how much excess there actually is. "Advisers will need to educate their clients on the possibility of expense recapture from recordkeepers, of the existence of the expense recapture accounts, and about the usage of these accounts," says Reish. Advisers should explain what a plan's precise costs are and how they are paid for, and then calculate precisely how much revenues actually exceed costs.

"In the past, if the plan sponsors hadn't been asking the questions, it was 'don't ask, don't tell,'" says Leslie Smith, Senior Vice President and National Defined Contribution Practice Northeast Leader of Aon Consulting. "Now, recordkeepers are being more open and forthcoming on their own. They will show the revenue they earned and be more transparent about costs."

Permissible Payments

The ERISA account is not discussed anywhere in the text of ERISA, but what is discussed and what has been precisely laid out by the DoL is a detailing of what expenses can be paid from plan assets and how "excess" funds may be reallocated to participant accounts. The account simply facilitates the use of revenues generated by plan assets that exceed the costs of administration to pay other legitimate plan administrative expenses, including, but not limited to, communications and education costs, adviser fees, and nondiscrimination testing. What cannot be paid from plan assets or the ERISA budget set-aside, however, are so-called "settlor expenses." These must be paid by the employer and include costs associated with establishing, designing, and terminating plans. The DoL prohibits using plan assets for settlor expenses, which are generally deemed to be for the benefit of the employer, not the plan.

Nor, as Reish emphasizes, may the assets be used "for the benefit of the plan sponsor." He also explains that advisers can handle the excess revenues being used in an ERISA account in two distinct ways. One is to deposit the money into the plan as an "allocated account." Those funds then can be used to pay off appropriate plan expenses during the year. Any money in that ERISA account that has not been

expended at year's end must be paid back to participants, according to Reish. It cannot be carried over into the next calendar year.

Alternatively, those excess revenues can, in essence, be left on account with the recordkeeper as a credit that the plan can tap into at any time to pay for expenses. In this arrangement, the money—since it has not been deposited to the plan—does not have to be spent at the end of the year, and can be carried over as a credit to be used in the future.

Sometimes, especially if the excess is more than the plan might reasonably be able to spend in 12 months, it might make little sense to establish an ERISA account within the plan. "I don't want to dump a bunch of money into an ERISA account, because that money has to be spent," says Chepenik.

If advisers encourage plan fiduciaries to reallocate the dollars directly back to participants, rather than use the ERISA account to cover expenses, there are two ways to go about it. One is to give participants a prorated share, based on the size of their account balances. The other is to give them each an identical amount. "That's one of the discussion points right now," says Miller. "How do you achieve the most fair practice of getting that revenue back to the employees?"

A Job for an Adviser

"It's the adviser's role to help figure out and help explain all of the economics, all of the components of the fee structure of a mutual fund," Chepenik says, "and to calculate approximately how much money is being regenerated on the plan, and to benchmark how much money the client should be paying."

Moreover, the adviser generally is best positioned to explain options to plan fiduciaries when an excess is available. Mark Wetzel of Fiduciary Investment Advisors of Windsor, Connecticut, says good advisers will look to help their plan sponsors discover excess revenues that can be used in an ERISA account. "They should always be pressing for providers to disclose their fees and create budgets where they can for their clients' use," Wetzel urges.

To address the overpayment problem, the adviser needs to track the excess revenue, based on how much is being earned and how much is being paid out in costs, whether the arrangement is through revenue-sharing or 12b-1 or subagency transfer fees. Then, the adviser can determine whether it makes more sense to establish an ERISA account or to negotiate with the vendor for lower-cost investment funds.

Chepenik says advisers also should be looking at what is happening with other plans when it comes to tracking costs and revenues and recapturing excess dollars. "We're seeing a wide range of cost-to-heads of administering a plan," he says. "That clearly shows the vendor doesn't have a consistent way of pricing a plan." When account balances were smaller, the recordkeepers' profit margins were likely smaller, so the revenue-sharing to go into ERISA accounts was not nearly as significant as it now might be.

"The problem all along has been that we haven't known where the revenue is going and, as a result, we haven't been able to lower expenses for employees," Miller points out. "The act of creating an ERISA budget doesn't, in fact, lower the actual expenses, but the account enables you to give better share classes for employees when you determine what the revenue is that the providers are collecting, based on the assets of the plan."