



## Plan Fiduciary's Guide to Understanding Defined Contribution Plan Expenses

Including Revenue Sharing, Fund Leveling, and Share Class Optimization

Plan fiduciaries today may be concerned about managing their obligations with respect to plan expenses. Strict rules govern which kinds of expenses can be paid from plan assets, and regulations require fee disclosures at two levels — from service providers to sponsors and from sponsors to participants. In addition, litigation largely focused on fee reasonability has increased in recent years. But the issues today go further, extending to concerns about how expenses are paid and allocated. And since the Department of Labor (DOL) allows considerable flexibility, expense arrangements continue to evolve.

As part of their fiduciary responsibilities, plan fiduciaries should understand the various options available and continually evaluate them to determine how best to pay and allocate expenses for their plan. As with any fiduciary decision, documenting the process is crucial.

- With respect to expenses, fiduciary responsibilities, as well as participant litigation, have increased in recent years
- Flexibility around fee arrangements means solutions continue to evolve
- Fiduciaries have an obligation to understand available options and adopt arrangements that make most sense for their plan

### Paying Expenses From Plan Assets

Services related to the operation of a plan typically include investment management, recordkeeping, compliance, consulting and/or advisory.

The only expenses that can legally be paid from plan assets are those for services that benefit plan participants exclusively. So while the plan sponsor must absorb so-called “settlor” expenses associated with establishing, amending or terminating a plan, other expenses can legitimately be charged against plan assets, broadly classified into three groups:

INVESTMENT MANAGEMENT	ADMINISTRATIVE	SERVICE
For professionally managed investment options, often mutual funds.	For providers who perform services for the ongoing operation and maintenance of the plan.	For specific participant services, such as loans.
<b>If participant pays, how?</b>		
Typically included in fund expense ratio which is netted from fund returns.	All or a portion may be included in fund expense ratios or charged as explicit fee to participant accounts.	Charged against accounts of individuals using specific service.

Plan fiduciaries may have their participants pay the costs associated with operating the plan, so it is common practice to see a portion, if not all, eligible expenses charged to the plan. However, expenses paid by the plan reduce participant returns and therefore put additional responsibility on the plan fiduciary who must monitor them to be sure they are reasonable.

When charging expenses to participants, investment management and service expenses are fairly straightforward: it's reasonable that participants are charged investment management expenses based on the funds in which they are invested, and service expenses are typically levied against those participants who use specific services.

There are significantly more options around payment arrangements for administrative expenses, which warrant additional consideration. Specifically, plan fiduciaries should be making active decisions as to:

- Whether expenses should be paid by participants or the company;
- Whether expenses should be paid directly or indirectly, via revenue sharing;
- If expenses are paid by participants, how they should be allocated (i.e., flat dollar or percentage of assets).

*In the pages that follow, we will review these considerations to help plan fiduciaries make informed decisions.*

### Who Should Pay for Administrative Expenses?

Just because the DOL allows administrative expenses to be charged to participants, it doesn't mean that they automatically should be. In fact, in many cases, the company pays the expense in order to take advantage of some of the benefits described below:

#### BENEFITS TO PLAN SPONSOR OF PAYING FOR 401(K) PLAN EXPENSES

<b>Less Fiduciary Liability</b>	Paying expenses from company coffers reduces the risk of being sued by participants for expenses they paid.
<b>Lower Taxes</b>	401(k) expenses paid by the company are typically a tax-deductible business expense.
<b>Enhanced Plan Returns</b>	Fewer expenses charged to the plan means participants keep more of their investment returns.
<b>Improved Participant Experience</b>	Eliminating administrative expenses simplifies the conversation, increases transparency and helps participants appreciate the value of the plan.



### Allocating Administrative Expenses to Participants: Flat Dollar or Percentage of Assets?

Once plan fiduciaries have determined to charge expenses to the plan, the next question is how they should be allocated to individual participant accounts: as a flat dollar amount or as a percentage of assets?

#### Flat Dollar Allocation Method

Under the flat dollar method, the total expense is divided by the number of plan participants, and each participant is charged the same dollar amount. For instance, if a \$25 million plan with 1,000 participants incurs \$87,500 in administrative expenses, each participant would be charged \$87.50.

#### FLAT DOLLAR METHOD: AN EXAMPLE

\$25 million plan; 1,000 participants; \$87,500 in expenses

ACCOUNT VALUE	FLAT DOLLAR EXPENSE CHARGED TO PARTICIPANT ACCOUNT	IMPACT AS PERCENTAGE OF ACCOUNT VALUE
\$1,000	\$87.50	8.75%
\$500,000	\$87.50	0.0175%

HYPOTHETICAL EXAMPLE. FOR ILLUSTRATIVE PURPOSES ONLY

#### Percentage of Assets Allocation Method

Under the percentage of assets method, every participant is charged the same rate. In our example, since the \$87,500 administrative fee equates to 0.35% of assets, that is the rate that would be charged to each participant account.

#### PERCENTAGE OF ASSETS METHOD: AN EXAMPLE

\$25 million plan; 1,000 participants; \$87,500 in expenses

ACCOUNT VALUE	PERCENTAGE OF ASSETS EXPENSE CHARGED TO PARTICIPANT ACCOUNT	IMPACT AS DOLLAR AMOUNT
\$1,000	0.35%	\$3.50
\$500,000	0.35%	\$1,750

HYPOTHETICAL EXAMPLE. FOR ILLUSTRATIVE PURPOSES ONLY

As you evaluate these options, keep in mind that the flat rate may result in participants with lower balances paying expenses that are higher in relation to their total account, while the percentage of assets method could result in participants who are older and closer to retirement paying a larger dollar amount.

### Understanding Revenue Sharing

Historically, administrative expenses have been paid on an indirect basis through a practice called “revenue sharing,” which simply means that a portion of the revenue collected through a fund’s expense ratio is “shared” with third parties for the services they are providing to the plan. For instance, a mutual fund may pay a recordkeeper revenue sharing to offset the cost the recordkeeper incurs to maintain individual account records for each participant. In this example the mutual fund does not maintain individual account records and is therefore sharing revenue with the recordkeeper for maintaining the accounts.

When plan participants invest in a fund, they pay expenses in the form of an expense ratio, which is netted from the fund’s returns. For example:

	TOTAL EXPENSE RATIO	REVENUE SHARING (%)
Fund ABC	1.10%	0.45%

HYPOTHETICAL EXAMPLE. FOR ILLUSTRATIVE PURPOSES ONLY

A participant with a \$10,000 investment in Fund ABC would incur an annual total expense of \$110, collected by the fund company. The fund company would transfer \$45 to the service provider to offset administrative expenses and would retain the \$65 balance as its investment management fee.

Since different funds have different revenue sharing amounts, overall plan asset allocation (i.e., how plan participants in aggregate choose to invest among available funds) will impact whether the revenue generated is enough to cover the expenses.

#### ERISA Budget Accounts

Monies collected through revenue sharing to pay for plan expenses may be held in a specially designated account, sometimes referred to as an “ERISA Budget Account.” This account is held within the plan and allows plan fiduciaries to track revenue sharing and to also easily pay eligible expenses from the plan. Individual recordkeepers may have different rules relating to how ERISA budget accounts are maintained and if at the end of the year there is a balance in the account, that amount may be allocated back to participants or it might remain in the account to cover future expenses. If the amount in the ERISA budget cannot cover all of the expenses, the plan fiduciaries will need to decide whether to charge the remaining expenses to the participants or pay them from company assets.

### Additional Considerations With Revenue Sharing

Plan fiduciaries should be familiar with two concepts relating to revenue sharing arrangements: Share Class Optimization and Expense Leveling (or Equalization).

#### Share Class Optimization

To accommodate plans with different administrative expense amounts, fund companies offer multiple share classes with different expense ratios and corresponding revenue sharing percentages. For instance:

##### Different Share Classes Have Different Expense Ratios and Revenue Sharing

FUND/SHARE CLASS	TOTAL EXPENSE RATIO	REVENUE SHARING (%)	NET INVESTMENT EXPENSES
Fund ABC Share Class I	1.10%	0.35%	0.75%
Fund ABC Share Class II	0.85%	0.25%	0.60%
Fund ABC Share Class III	0.65%	0.00%	0.65%

HYPOTHETICAL EXAMPLE. FOR ILLUSTRATIVE PURPOSES ONLY

This allows a plan fiduciary to choose share classes based on the revenue sharing amount that most closely corresponds to the amount of plan administrative expenses.

As demonstrated in the above example, a plan fiduciary who selected Share Class III based on the expense ratio might be surprised to learn, upon closer inspection, that their participants are paying a higher net expense than Class II investors.

When selecting funds for their plan, fiduciaries should look at all the elements of the expense ratio. While zero revenue share funds may appear at first glance to be the cheapest share class because they exclude amounts to help offset administrative expenses, they can in fact be more costly in terms of overall net expenses.

### Expense Leveling

Under the standard revenue sharing approach, participants do not always equally share the administrative costs. Consider, for instance, three plan participants, all invested in different funds with different revenue sharing amounts:

#### STANDARD REVENUE SHARING

	FUND	ACCOUNT BALANCE	FUND REVENUE SHARING (%)	ADMINISTRATIVE COSTS PAID
Sam	Fund A	\$25,000	0.00%	\$0.00
Monica	Fund B	\$25,000	0.25%	\$62.50
Emily	Fund C	\$25,000	0.35%	\$87.50

HYPOTHETICAL EXAMPLE. FOR ILLUSTRATIVE PURPOSES ONLY

Effectively, participants in funds with revenue sharing are paying more than participants invested in funds with no revenue sharing. The example above is simplified, but the effect could be even more significant depending on the specific funds used in a plan, different participant account balances, and different participant fund allocations.

Plan fiduciaries who are concerned about this may want to consider one of the following methodologies to ensure that all participants are paying expenses equally:

- Zero Revenue Sharing.
  - Use funds with no revenue sharing.
- Revenue Sharing With Expense Leveling.

Expense leveling is not legally required, and the DOL has not formally come out in favor of it; however, the practice is gaining traction as a “best practice.”

Even if a plan sponsor decides not to implement fee leveling, they should understand the issues and the available options.



### Zero Revenue Sharing Using Funds With No Revenue Sharing

In this scenario, plan fiduciaries choose only funds that have no revenue sharing. In other words, the fund's expense ratio consists entirely of the investment management fee. The plan fiduciary can then separately charge each participant account (using either the flat dollar or asset-based approach) the administrative expenses. In this example, the plan sponsor has decided to use the asset-based approach:

#### ZERO REVENUE SHARING USING FUNDS WITH NO EMBEDDED REVENUE SHARING

	FUND	ACCOUNT BALANCE	FUND REVENUE SHARING (%)	ADMINISTRATIVE EXPENSE CHARGED TO EACH PARTICIPANT ACCOUNT (%)	ADMINISTRATIVE COSTS PAID
Sam	Fund A	\$25,000	0.00%	0.35%	\$87.50
Joe	Fund B	\$100,000	0.00%	0.35%	\$350.00
Meg	Fund C	\$50,000	0.00%	0.35%	\$175.00
John	Fund D	\$50,000	0.00%	0.35%	\$175.00
Marie	Fund E	\$100,000	0.00%	0.35%	\$350.00

HYPOTHETICAL EXAMPLE. FOR ILLUSTRATIVE PURPOSES ONLY

### Crediting Back All Revenue Sharing

Plan fiduciaries may feel constrained having to choose from only those funds with no zero revenue sharing. Even if a plan lineup includes funds with revenue sharing, plan fiduciaries can effectively achieve zero revenue sharing by crediting back all revenue sharing received from each fund company, then charging each participant account the same administrative fee:

#### ZERO REVENUE SHARING BY CREDITING BACK ALL REVENUE SHARING

	FUND	ACCOUNT BALANCE	FUND REVENUE SHARING (%)	FUND REVENUE SHARING CREDITED BACK TO PARTICIPANT ACCOUNT (%)	ADMINISTRATIVE EXPENSE CHARGED TO EACH PARTICIPANT ACCOUNT (%)	ADMINISTRATIVE COSTS PAID
Sam	Fund A	\$25,000	0.00%	0.00%	0.35%	\$87.50
Joe	Fund B	\$100,000	0.10%	0.10%	0.35%	\$350.00
Meg	Fund C	\$50,000	0.25%	0.25%	0.35%	\$175.00
John	Fund D	\$50,000	0.35%	0.35%	0.35%	\$175.00
Marie	Fund E	\$100,000	0.50%	0.50%	0.35%	\$350.00

HYPOTHETICAL EXAMPLE. FOR ILLUSTRATIVE PURPOSES ONLY

### Revenue Sharing With Adjustments

Finally, expense leveling may be achieved by applying the appropriate credit or fee to each account (at the fund level) so that the actual administrative fee is the same for all participants:

#### REVENUE SHARING WITH ADJUSTMENTS

	FUND	ACCOUNT BALANCE	FUND REVENUE SHARING (%)	FUND REVENUE SHARING ADJUSTMENT (%)	ADMINISTRATIVE EXPENSE CHARGED TO EACH PARTICIPANT ACCOUNT (%)	ADMINISTRATIVE COSTS PAID
Sam	Fund A	\$25,000	0.00%	(0.35%)	0.35%	\$87.50
Joe	Fund B	\$100,000	0.10%	(0.25%)	0.35%	\$350.00
Meg	Fund C	\$50,000	0.25%	(0.10%)	0.35%	\$175.00
John	Fund D	\$50,000	0.35%	0.00%	0.35%	\$175.00
Marie	Fund E	\$100,000	0.50%	0.15%	0.35%	\$350.00

HYPOTHETICAL EXAMPLE. FOR ILLUSTRATIVE PURPOSES ONLY

## Understand Your Responsibilities and Options

Since each plan is unique, plan fiduciaries should follow these steps in evaluating their plan's expense structure.

1. Review plan documents to determine whether they outline how certain expenses should be paid and/or allocated.
2. Collect information about all plan expenses, including direct and indirect expenses, as well as those paid by the plan sponsor or the participants.
3. For any expenses eligible to be paid by the plan assets, review the following:
  - **Who should pay for expenses?**  
Consider the benefits of having the plan sponsor absorb expenses.
  - **Should expenses be paid directly or indirectly?**  
Consider whether having funds with revenue sharing makes sense for the plan.
  - **How should charges to participant accounts be made?**  
Evaluate the impact on different employee groups based on the following methodologies: flat dollar or asset-based.
  - **Which fee arrangements can the plan provider handle?**  
For each of the alternatives being considered, be sure the plan provider can implement your preferred arrangement.
  - **Should the plan maintain an ERISA Budget Account?**  
Understand the benefits and responsibilities of maintaining an account through which revenue and expenses will flow.
  - **What are the investment management expenses in relation to the expense ratio?**  
If funds with revenue sharing are being used, be sure you have reviewed the investment management expenses.
  - **Does the investment lineup result in differences in administrative expenses paid by each participant?**  
If concerned about differences in administrative expenses paid by participants, review available fund leveling methods to determine the most appropriate solution.
  - **How are expense arrangements communicated to participants?**  
Using required disclosures and fee statements, review how easy it is for participants to understand all expenses they pay. Consider how any changes to expense arrangements will impact them and consider what can be done to enhance transparency and facilitate participant understanding.
4. Document analysis, discussions and decisions and be prepared to defend such decisions.
5. Monitor expense arrangements on an ongoing basis.

Plan fiduciaries should consult with their legal advisors when managing their obligations with respect to plan expenses.

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