

# Payment Arrangements

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Counting all share classes (A, B, C, D, I, R) there are more than 22,000 mutual funds available today, which is more than the total number of publicly traded stocks. Within the mutual fund industry, a number of providers have adopted a “pay to play” business model.<sup>1</sup> The model promotes payment of hidden fees through revenue sharing practices which is an undisclosed fee arrangement.

## THE MOST CRITICIZED ISSUE

Under constant scrutiny, the most criticized issue in the investment management industry is investment fund fees and expenses.<sup>2</sup> In December 2001, Standard & Poor’s issued a public report concluding that mutual funds, with high expense ratios, performed poorly over a three-year period which prompted shareholders to ponder the return they earned in contrast to the fees they paid.

## DISTRIBUTION CHANNELS

Distribution channels consist of a diversity of service providers, which the investment companies wish to compensate for distributing their investment products. To compensate these entities, mutual fund companies have devised a variety of methods to pay for distribution.

Since the line between mutual fund company (investment product manufacturer) and distributor is indistinguishable, compensation to some entities is confusing. Take for example Merrill Lynch, Fidelity, U.S. Bank, Aetna, and Charles Schwab. All of these companies have their own investment products, and each of these firms also offer distribution services to the other mutual fund companies.

In this scenario, the investment product manufacturer is compensated for its investment product and the distributor is compensated for distributing the product; resulting, in increased costs for the investment product in order to pay distribution fees to a competing fund company.

## MARKETING AND DISTRIBUTION FEES

Marketing and distribution fees, referred to as 12b-1 fees, are the primary method exploited in the fund industry in order to pay the costs for distributing their funds. The fee is deducted from fund assets and may range from 0.20 percent to 1.25 percent.



Since the adoption of 12b-1 fees by the SEC in 1980, fund companies have used the fees, in combination with deferred sales charges, as an alternative to front-end sales loads.

## REVENUE SHARING

Mutual fund companies charge management fees for managing the fund’s portfolio of securities. Fund companies often engage in revenue sharing with third parties by paying a portion of its management fee to cover the cost of services provided to retirement plans; such as administration, record keeping, and investment advice. This type of fee payment represents hidden fees since the payment arrangement is not disclosed in the fund prospectus.

## SHAREHOLDER SERVICING FEE

Shareholder servicing fees are typically paid to the fund's transfer agent, or to other groups, for performing services; such as communication, administration, recordkeeping, WEB site, and computerized account services. The fee ranges from 25 to 150 basis points.

Typically, a company that pays a shareholder servicing fee lists, in its expense disclosure, as "not paying a 12b-1 fee."

## SUB-TRANSFER AGENT FEE (SUB-TA)

Sub-transfer fees represent a portion of the compensation normally paid to a fund transfer agent. Instead, the fee is diverted to another service provider who performs administration or recordkeeping services. The fee can be paid as a fixed fee on a per-participant basis, an asset-based fee, or a combination of both.

## FINDER'S FEE

A finder's fee represents a one-time payment for the placement of money with the fund company. New contributions to the fund also qualify for the finder's fee.

The fee is paid out of the mutual fund companies' own resources and ranges from 25 to 200 basis points of new money.<sup>3</sup>

## COLLECTIVE INVESTMENT FUND FEE

The last form of revenue sharing is a collective investment fund fee. Trust vehicles (collective investment trusts), dedicated to retirement plan clients, may pay a revenue sharing fee of up to 0.50 percent.<sup>4</sup>

## MULTIPLE SHARE CLASSES

Multiple share classes were introduced as an alternative to funds which only charged front-end and back-end loads, in order to compensate brokers and service firms for distribution.

A typical fund with seven share class offerings:

**Institutional class:** no 12b-1 fee and no service fee, with an expense ratio of 50 bps

**Investor class:** no 12b-1 fee, 10 bps service fee and an expense ratio of 60 bps

**Trust class:** 25 bps 12b-1 fee and 25 bps service fee, with expense ratio of 100 bps

**A class:** Front-end load of 5%, 25 bps 12b-1 fee and 25 bps service fee, with expense ratio of 125 bps

**B class:** Back-end load of 5% Yr. 1, 25 bps 12b-1 fee and 25 bps service fee, with expense ratio of 200 bps

**C class:** Front-end load of 1%, 100 bps 12b-1 fee and 25 bps service fee, with expense ratio of 200 bps

**R class:** 100 bps 12b-1 fee and 25 bps service fee, with expense ratio of 200 bps (R class shares are only sold to retirement plans)

## MOST COMPANIES ARE IN THE DARK

The seriousness of high fund fees and lack of disclosure was uncovered in a broad survey of plan sponsors conducted by Grant Thornton for the Department of Labor.

The survey found that 69 percent of sponsors didn't know what they paid in 12b-1 fees and 80 percent had no idea what they were paying in marketing fees, finder's fees, and additional "other" costs.<sup>5</sup> The survey also found that 81 percent of sponsors didn't know what they may have paid for sub-transfer agency fees.

## CONCLUSION

Throughout the investment industry, fees are charged and divided up in complicated ways. Who gets paid and how much is almost impossible to figure out.

The Department of Labor is weighing in with regulations on full fee disclosure with its 408(b)(2) project. Advisors can expect regulators to step up their efforts in investigating total expense ratios, and the disclosure and transparency of payments received by providers.

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<sup>1</sup> Revenue Sharing Aspects of Qualified Retirement Plan Management, by Gregory Kasten, MD, MBA, CFP®, President & CEO Unified Trust Co., NA

<sup>2</sup> Deloitte Touche 2002 Survey of Fees and Expenses for Global Collective Investment Funds commissioned by Investment Company Institute (ICI)

<sup>3</sup> How to build your business in the small 401(k) market, by Elayne Robertson Demby, 1 May 2005

<sup>4</sup> Revenue Sharing in the 401(k) Marketplace, "Whose Money Is it?" The McHenry Revenue Sharing Report

<sup>5</sup> Full fee disclosure: Ensuring accountability in 401(k) administration, Ceridian Connection March 2005