

401(K) INVESTMENT ISSUES

Department of Labor Focuses on Revenue Practices

What Are Your Fiduciary Duties Regarding Revenue-Sharing Arrangements?

This article is based on testimony drafted by Fred Reish and Stephanie Bennett that was delivered by Fred Reish to the Department of Labor Advisory Council Working Group on Fiduciary Responsibilities and Revenue Sharing Practices on September 20, 2007.

BY FRED REISH, BRUCE ASHTON,
AND STEPHANIE BENNETT

Fred Reish, Esq., is managing partner and chair of the ERISA practice at Reish Luftman Reicher & Cohen in Los Angeles, CA. Fred is an ERISA attorney whose practice focuses on fiduciary responsibility issues. He has written over 250 articles and four books about retirement plans, co-authors this fiduciary column, and writes a column on 401(k) fiduciary issues for *Plan Sponsor* magazine. He is a Charter Fellow of the American College of Employee Benefits Counsel and has been awarded the IRS Commissioner's Award, the IRS District Director's Award, and the ASPPA Eidson Founder's Award for his contributions to the benefits community. Fred co-chaired the IRS Los Angeles Benefits Conference for over ten years, served as a founding co-chair of the ASPPA 401(k) Summit, and serves on the steering committee for the DOL National Conference.

Bruce Ashton, Esq., is a partner of the law firm of Reish Luftman Reicher & Cohen, specializing in employee benefits matters. His practice focuses on all aspects of employee benefits issues, including representing plans and their sponsors in controversies before the IRS and DOL, resolution of plan qualification issues under IRS compliance programs, advising on fiduciary issues under ERISA, and structuring qualified plans, including employee stock ownership plans, and nonqualified deferred compensation arrangements. Bruce co-authored with Fred Reish the *Participant Directed Investment Answer Book* (3d Ed.), a Panel Publication. Bruce was president of the American Society of Pension Professionals and Actuaries (ASPPA) for the 2003 to 2004 term. From 1998 through 2002, he served as co-chair of ASPPA's Government Affairs Committee.

Stephanie Bennett, Esq., is an associate with the law firm of Reish Luftman Reicher & Cohen, practicing in the area of employee benefits law. Stephanie focuses her practice on advising both private- and public-sector entities regarding a variety of matters related to employee benefits. She also assists clients on complying with their benefit-related fiduciary duties. Stephanie has co-authored

several articles which have been published in the *Journal of Pension Benefits*, the *California CPA* magazine, and the *National Association of Government Defined Contribution Administrators* newsletter. She is also a member of the ASPPA DOL subcommittee.

The Department of Labor (DOL) Advisory Council Working Group on Fiduciary Responsibilities and Revenue Sharing Practices recently invited members of the benefits community to comment on revenue-sharing practices and more specifically the following issues:

- Whether the DOL should issue guidance with respect to the acceptable and proper use of plan revenues generated by revenue-sharing arrangements and in appropriate circumstances where there is excess revenue sharing (*i.e.*, revenue sharing that exceeds recordkeeping/administration fees), how such excess revenue sharing [should] be allocated to participants.
- Survey current practices to determine the manner in which plan sponsors/fiduciaries currently ensure understanding of revenue-sharing/fee arrangements.
- Determining what guidance the DOL should issue with respect to charging/debiting a participant's account and the crediting of participant accounts under specific circumstances.
- What a plan sponsor/fiduciary needs to know and a plan provider should be required to provide, when they enter into a revenue-sharing or rebate arrangement.

The Advisory Council then asked four specific questions. This article repeats those questions and discusses

the substance of our responses through written and verbal testimony:

What are the current practices as to revenue-sharing arrangements, including the basis upon which the revenue sharing is determined and the methods by which employers utilize the amounts shared?

The practice of revenue sharing is not only common in the industry, it is prevalent. As a result, there is a critical need for guidance.

Revenue sharing generally refers to a compensation practice in which money is paid to plan service providers out of 401(k) investments or by their managers (and affiliates). Some may quibble about the precise definition of revenue sharing and whether all forms of payments should be so labeled. However, in the 401(k) community, “revenue sharing” has come to mean payments that are directly or indirectly sourced in a plan’s investments, and that are paid to other providers without going through the plan. The DOL often refers to these as “indirect payments,” while plaintiffs’ attorneys call them “secret and excessive payments.” A feature of these payments is that, while they are sourced in a plan’s assets, the payments are “shared” by the plan’s providers, often without the knowledge of plan sponsors, fiduciaries, and participants.

In our discussion of revenue sharing, we assume all 401(k) investments are mutual funds, and we focus on three forms of revenue sharing. All three forms have, as their source, the participants’ investments in mutual funds. Stated slightly differently, the money for revenue sharing is extracted, directly or indirectly, from participants’ accounts and thereby reduces their retirement benefits. However, to the extent the charges are reasonable and the revenue sharing pays for services that are properly payable by a plan and to the extent those services provide value to the plan and its participants, the charges are offset by equivalent and appropriate value.

The first form of revenue sharing, 12b-1 fees, is used for the cost of the sale, or distribution, of investments. The fee is deducted from the assets of the mutual funds and thus is charged directly to the participants invested in that fund. The fee is ordinarily paid to a broker-dealer as a part of the distribution of the mutual fund. However, for small plans funded with group annuity contracts, it may be paid to subsidize the recordkeeping costs.

The second form of revenue sharing, subtransfer agency fees (or sub-TA fees), are also deducted from

the mutual funds’ assets. A mutual fund must maintain records of its shareholders and may properly pay for that service. Where an intermediary, like a record keeper, maintains those records, the mutual fund pays the record keeper for that service. Sub-TA fees are typically fixed fees on a per-participant basis or asset-based fees, or a combination of both. [Pozen, Robert C., *The Mutual Fund Business*. Boston: Houghton Mifflin Company, 2002.] The transfer agent also provides other shareholder services, such as administration, compliance, communications, and other operational services; the fees for these services, in the aggregate, are referred to as shareholder servicing fees.

The third form is that the mutual fund investment management firm, or an affiliate, may pay a portion of its management fee to a third party as a form of revenue sharing. For example, a mutual fund manager or affiliate may pay a bonus payment to a broker/dealer based on a specified sales goal or total volume of business retained. The source of this money is the fee for managing the portfolio of securities held by the mutual fund that is charged to the fund by the investment manager. Management fees are also charged directly to the mutual fund’s assets, thereby reducing participants’ benefits.

Revenue-sharing arrangements vary based on the dollar amount of the investments in a plan. The best way to understand the variance in revenue-sharing arrangements among plans of different sizes is through examples. (The following ranges for plan sizes are somewhat arbitrary, but generally correct.)

In large plans (that is, plans with \$100 million or more in assets), there ordinarily would not be any 12b-1 fees paid to a broker-dealer. In most cases, however, the record keeper would receive fees for performing the transfer agent function and other shareholder services. However, sophisticated plan sponsors (which you would expect at this size of plan and company) often negotiate a fixed fee for recordkeeping services, and revenue sharing is offset against that fixed cost. If the revenue sharing exceeds that cost, the excess is restored to the plan. If the revenue sharing is not enough to cover the costs, the plan usually pays the difference, and the participants’ benefits are reduced by the amount of that payment (although some employers may absorb those charges).

For mid-market plans (plans with \$10 million to \$100 million in assets—and particularly the lower half of that range), it is relatively common for plans to hold mutual funds that pay 12b-1 fees to a broker-dealer. For these plans, the record keeper also receives

revenue-sharing fees for performing the transfer agent function and some shareholder services. For some of these plans, the fiduciaries negotiate for the recapture of excess revenue sharing, particularly if they are advised by a knowledgeable consultant. In some cases, the excess is deposited into the plan and used to pay other expenses during the course of the year, with any remaining balance allocated to participants' accounts at the end of the year. In other cases, the excess is held by the providers as a "credit" balance which may be used to pay plan expenses. However, the credit balance belongs to the provider by contract and thus is not considered a plan asset.

For small plans (plans with \$10 million or less in assets), the practices vary. For example, for a plan offered by a mutual fund family (often with a limited number of outside investments), the 12b-1 fees are paid to the broker-dealer, with the affiliated record keeper receiving the sub-TA fees from the third-party funds and credits from related (or proprietary) funds. This arrangement also may include additional direct charges to the plan or the plan sponsor. For an insurance product (e.g., a group annuity contract), both the 12b-1 and subtransfer agent fees also are often paid to the provider. The insurance company provider retains those amounts to cover the costs of its recordkeeping and other services, and pays the broker through a separate asset charge. The retention of the 12b-1 fees is usually based on the additional services provided to the plans and their participants, that is, insurance providers often offer a robust set of investments and services to small plans.

These descriptions are intended to cover the most common practices. There are exceptions to each of these cases. For example, the higher end of the small plan market has, in recent years, become more competitive and, as a result, is becoming more similar to the mid-market.

In addition, revenue-sharing arrangements vary depending on whether the plan sponsor has selected a "bundled" or "unbundled" provider. Plan sponsors that select "bundled" providers receive both administrative and investment services from a single provider. Typically, bundled providers offer proprietary as well as third-party investments. In those cases, the bundled provider will receive revenue sharing from the third-party investments based on a percentage of participant assets invested in those funds. Those fees, along with the management fees (and possibly 12b-1 fees) from the proprietary funds, are used to offset the cost of providing administrative services, such as recordkeeping and

compliance. Many bundled providers credit their retirement services division for a portion of their investment management revenues from the proprietary investments held in the plans on their recordkeeping platforms. That crediting may be higher than the rate of revenue sharing paid by third-party mutual funds—thus creating an incentive for the retirement services division to encourage the use of proprietary funds—a potential conflict of interest. In effect, that crediting process is the functional equivalent of revenue sharing. As a result, disclosure would help plan sponsors and fiduciaries compare the revenue-sharing payments and credits and evaluate the conflicts for competing investments.

What, if any, guidance should the DOL issue with respect to the obligations of plan sponsors, trustees, and other fiduciaries regarding the allocation of revenue-sharing payments received by the plan from the service provider?

Although the DOL has issued three Advisory Opinions that provide insight into its views on revenue sharing [*See* DOL Advisory Opinions 97-15A (the Frost Opinion), 97-16A (the Aetna Opinion), and 2003-09A (the ABN AMRO Opinion)], those letters do not address a fundamental question. That question is whether revenue-sharing payments are plan assets. If revenue-sharing amounts are plan assets, those amounts must be held for the "exclusive purpose" of providing retirement benefits for participants and beneficiaries and are subject to the ERISA section 406(b) prohibited transaction rules.

A recent district court decision highlights this issue. [*Haddock v. Nationwide Financial Services, Inc.*, 419 F. Supp. 156 (D. Conn. 2006)] In that case, the trustees of a 401(k) plan asserted that Nationwide's contractual agreements with mutual funds and its retention of revenue-sharing payments constituted breaches of its fiduciary duties and prohibited transactions under ERISA. The matter came before the court on a motion for summary judgment. In considering the motion, the court found that there was no guidance that addresses whether revenue-sharing payments are plan assets:

ERISA provides no explicit definition of "plan assets." No regulation or case law provides a definition of "plan assets" that answers whether fees, arguably received in exchange for services provided, that are paid to an ERISA fiduciary in connection with its fiduciary functions and that may be at the expense of a plan, constitute plan assets. [*Id.* at 167 (Internal citations omitted.)]

Since this issue remains unresolved, the DOL needs to issue guidance about whether revenue-sharing payments constitute plan assets.

A closely related issue is whether fiduciaries have a responsibility to investigate, or even negotiate, for the return of “excess compensation” (*i.e.*, revenue sharing) to their plans.

In recent years, as 401(k) plans have increased in size, the costs of operating a plan generally have not grown as rapidly as the increase in plan assets. Since some plan expenses—and particularly investment-related expenses—are calculated as a percentage of plan assets, in some cases the revenues of providers (including the revenue sharing they receive) have grown to exceed the reasonable charges of doing business. Sophisticated consultants, plan sponsors, and fiduciaries have negotiated for the restoration to the plans of the amounts that exceed reasonable charges. Also, some providers (particularly independents, banks, and trust companies) have adopted a business model of charging a set fee for their services, offsetting all revenue sharing, and restoring excess amounts to the plans.

Those excess amounts are usually paid into a “suspense,” or unallocated, account, which is used to pay plan expenses—with any remaining amounts allocated to the participants at the end of each year. In the industry, these are often referred to as “ERISA accounts.”

Undoubtedly, in many cases providers would restore excess amounts of revenue sharing to plans—if fiduciaries investigated and negotiated for that restoration. A reasonable interpretation of the prudent man rule is that fiduciaries must act on the participants’ behalf to obtain this “free money” for the plan. An alternative for fiduciaries of plans with “excess” revenue sharing is to change to a share class of mutual funds with a lower expense ratio, thereby reducing the revenue-sharing amounts *and* the expenses being paid by the participants.

Based on our experience, the costs for operating 401(k) plans with less than \$5 million in assets are high enough that, relative to the revenue sharing received, there are almost no opportunities for the recovery of excess revenue sharing. For 401(k) plans with between \$5 million and \$10 million in assets, though, we are beginning to see amounts restored to plans.

Guidance is needed to educate fiduciaries of their responsibilities and inform them of these opportunities. Therefore, the DOL should issue specific guidance on the duties of fiduciaries to investigate revenue

sharing and the possibility of restoration of excess amounts.

A related issue is the allocation of revenue-sharing payments received by plans.

There is no specific guidance regarding the allocation of revenue-sharing payments; however, two Field Assistance Bulletins (FABs) provide insight into the DOL’s approach to allocation methods. While the FABs address other issues—the allocation of plan expenses and settlement fees—their reasoning sheds light on the DOL’s thinking about allocation methods for revenue sharing. In FAB 2003-03, the DOL provided guidelines for ERISA fiduciaries regarding the allocation of expenses in defined contribution plans, advising that a fiduciary must follow a prudent process and act solely in the interest of participants:

A plan fiduciary must be prudent in the selection of the method of allocation. Prudence in such instances would, at a minimum, require a process by which the fiduciary weighs the competing interests of various classes of the plan’s participants and the effects of various allocation methods on those interests. In addition to a deliberative process, a fiduciary’s decision must satisfy the “solely in the interest of participants” standard. In this regard, a method of allocating expenses would not fail to be “solely in the interest of participants” merely because the selected method disfavors one class of participants, provided that a rational basis exists for the selected method.

The FAB acknowledges that the allocation method may differ based on the type of expense but must nonetheless bear a reasonable relationship to the nature of the expense. “On the other hand, if a method of allocation has no reasonable relationship to the services furnished or available to an individual account, a case might be made that the fiduciary breached his fiduciary duties to act prudently and ‘solely in the interest of participants’ in selecting the allocation method.”

For example, the FAB provides that the pro rata method (*i.e.*, allocations made on the relative basis of assets in individual accounts) of allocating expenses among participants would, in most cases, be equitable. However, it is not the only permissible method. Another method is the per capita method (*i.e.*, expenses charged equally to each account, without regard to the amount of assets in each account).

In FAB 2006-1, the DOL provided guidance on the allocation of mutual fund settlement proceeds resulting from market timing and late trading violations. If the mutual fund consultant’s distribution

plan does not contain a method for allocating the proceeds among participants, a method must be used that relates to the impact of the market timing and late trading activities on the participant accounts. Plan administrators are permitted to weigh the costs to the plan and participant accounts and the ultimate benefit to participants when trying to determine how to allocate settlement proceeds, taking into account matters such as the availability of plan records and the costs of different allocation methodologies. For example, the FAB suggests that it may be permissible to allocate the proceeds to current participants, rather than participants who participated in the plan during the relevant period (*i.e.*, when market timing/late trading occurred). In addition, the FAB acknowledges that in certain situations the amounts involved may be so small that the plan administrator might conclude that the expense of allocating the amounts is not cost-effective, and use the amounts to pay plan expenses.

Applying this guidance to the allocation of revenue sharing, fiduciaries need to be granted flexibility and discretion to determine whether, for example, a pro rata allocation is appropriate or whether a more precise calculation can be done in a reasonable and cost-effective manner. By definition, a method of allocation based on account balances at the end of the year is not the most precise method. However, precise calculations may be prohibitively expensive and administratively burdensome considering the amounts to be allocated. Thus, in most cases, a pro rata allocation based on end-of-the-year account balances would be a reasonable method. But, it may not always be the right answer.

Consider, for example, two types of investments that may have the greatest divergence in revenue sharing (particularly for small plans)—stable value investments and an S&P 500 fund. It is not unheard of for a stable value investment to revenue share as much as 75 to 100 basis points per year, while a low-cost index fund may not revenue share at all. In that case, if two participants have the same account balances, but one is invested entirely in the stable value vehicle while the other is entirely in the index fund, a pro rata allocation based on account balances raises obvious issues for fiduciaries—because one participant bore the entire cost of operating the plan through revenue-sharing fees. While this is an extreme example, the reality is that, for many small and mid-sized plans (and perhaps some large plans), the costs borne by participants for operating the plans may vary significantly. While that fact may raise fiduciary issues in its own right, our focus is on the prudent and equitable allocation of

excess revenue sharing to the participants' accounts. Should it be allocated in proportion to the amounts charged to each participant to generate the revenue sharing? Conceptually, the answer is, yes, it should be. However, practically speaking, that may not be possible—at least at this time (although we are aware of one large plan that is doing exactly that).

Fiduciaries need guidance on this issue similar to the guidance provided by the referenced Field Assistance Bulletins. In addition, the DOL and IRS should coordinate such that their rules are consistent on this issue. Specifically, the IRS should recognize cost as a factor in selecting an acceptable allocation method.

In recognition of the variety of revenue-sharing arrangements, any guidance on allocation methods for revenue sharing should build in flexibility and discretion so the fiduciaries may reasonably consider the material factors for determining the most appropriate method of allocation.

Finally, a tangential issue surfaces when considering the proper allocation of revenue-sharing payments. That issue is—how long may that money remain in the plan before it is allocated? Typically, when revenue-sharing amounts are deposited into a plan they are initially placed into an unallocated account, sometimes referred to as a suspense account. Guidance in the form of a Revenue Ruling provides that, in general, money in a defined contribution plan must be allocated to participants' accounts on an annual basis [*See* Rev. Rul. 80-155]. As a general statement of the qualification standards under the Internal Revenue Code, amounts held in a defined contribution plan must be allocated to participants' accounts on an annual basis unless there is specific authority allowing the money to be held unallocated beyond that time. Since there is no specific authority for the creation of a suspense account for retaining recaptured revenue-sharing payments (or similar revenues), the only reasonable conclusion is that those amounts must be allocated to participant accounts on an annual basis.

DOL guidance regarding the allocation of revenue-sharing payments should be coordinated with the IRS to avoid conflicting guidance.

What guidance could the DOL offer with respect to what a plan sponsor needs to know and what service providers should be required to provide when they consider a revenue-sharing arrangement?

The DOL is pursuing two initiatives to help plan sponsors and fiduciaries obtain the information needed

to understand and evaluate revenue sharing. Those are the DOL's project to amend the regulations under ERISA section 408(b)(2) and the revision of Schedule C to the Form 5500 for 2009. Those changes will greatly improve the quality of information by transferring the responsibility from a fiduciary duty to investigate to a provider duty to disclose.

Specifically, the DOL recently released proposed amendments to the regulation under ERISA section 408(b)(2) with respect to the definition of a reasonable contract or arrangement. In the proposed regulation, the DOL is requiring the following categories of information to be disclosed in order to satisfy the exemption: (i) information the fiduciary needs in order to determine if the contract or arrangement is reasonable (including information on indirect payments, like revenue sharing); and (ii) information regarding conflicts of interest. (Given the publication schedule of this article, it is not possible to provide detailed comments on the proposed regulation.)

Beginning with the 2009 plan year, plan sponsors will have to disclose information regarding revenue sharing in the Form 5500. In particular, a significant change to Schedule C requires reporting of direct or indirect compensation paid by the plan or received by a provider. The DOL states in the Instructions to the proposal (and we assume the final version will retain those instructions):

For purposes of this Schedule, reportable compensation includes money or any other thing of value (for example, gifts, awards, trips) paid by the plan or received from a source other than the plan or the plan sponsor by a person who is a service provider in connection with that person's position with the plan or services rendered to the plan.

They also provide examples of indirect compensation, including:

[F]inders' fees, placement fees, commissions on investment products, transaction-based commissions, subtransfer agency fees, shareholder serving fees, 12b-1 fees, soft-dollar payments, and float income. Also, brokerage commissions or fees (regardless of whether the broker is granted discretion) are reportable whether or not they are capitalized as investment costs.

However, since Schedule C is only required to be filed for large plans, the new reporting will not apply to all plans. (A large plan is one with 100 or more participants, but the Schedule C requirement also applies

to plans that have between 80 and 100 participants as of the beginning of the plan year, were large plans in the prior year, and elect to file as a large plan even though they have fewer than 100 participants.) In future, the reporting rules in revised Schedule C may apply to all plans. That is, the DOL may exercise its authority to require small plans to report information on the 5500 identical to that required on the new Schedule C.

In order for the information regarding revenue-sharing fees to be understandable and presented in a manner that allows fiduciaries to evaluate the information, all providers should have to present their fees, expenses, and revenue sharing in the same way. If that information is presented in different ways by different providers, it will be difficult for plan sponsors to readily compare provider fees (and it may be virtually impossible for smaller, less sophisticated plan sponsors to do the analysis). In addition, for bundled providers that use internal crediting (where credits are given by the investment management division to an affiliated record keeper because of the use of proprietary investments), those providers should disclose the crediting (or, alternatively, if the investment manager offers mutual funds through other providers, their highest revenue-sharing payments should be reported).

To assist plan sponsors in understanding revenue-sharing arrangements, data on expenses should be divided into three categories:

1. Investment-related expenses ("investment expenses")
2. Recordkeeping and administration expenses, which include communications, compliance, and other services related to the operation of a plan ("administrative expenses")
3. Investment consulting, brokerage, or advisory services ("advisory expenses")

The first category, investment expenses, covers the costs for the investments. For example, for a mutual fund, it would be the expense ratio of the mutual fund, including the management fee of the advisory firm. However, that data needs to be modified because of the unique characteristics of 401(k) plans. The amount of revenue from the investments that is paid (or credited) to either of the other two categories (administrative and advisory services) should be subtracted from the investment costs. That would include, for example, fees or commissions that are paid to the broker, consultant, or adviser. It also includes any subsidy paid for

recordkeeping and administration. The resulting “net” number is the true cost of the investments.

The second category, administrative expenses, includes any charges for recordkeeping, administration, compliance, communications, and other operational services, as well as any revenue sharing or other payments received from the investments. Those revenue-sharing payments typically include subtransfer agency fees and other shareholder servicing fees.

The third category, advisory expenses, covers any amounts paid directly by the plan to consultants, advisers, or brokers, as well as any indirect payments (that is, any payments or benefits from any source, but most likely from the investments or companies related to the investments). That includes, for example, finder’s fees, 12b-1 fees, volume bonuses, and so on.

Equipped with this information, plan sponsors and fiduciaries will be in a position to evaluate the services they are receiving in each of the three categories, with the costs properly allocated for purposes of that comparison. While no system is perfect, and this one is not either, the information would be a higher quality than is currently generally available, and would be

much more useful to fiduciaries in performing their duties.

Should the DOL develop a model prototype in this area?

Disclosure of revenue sharing may not lend itself to a prototype or model. However, the DOL should require that disclosures of revenue-sharing payments be broken out into appropriate and comparable categories, such that plan sponsors can readily compare revenue sharing among providers. Reporting should be done, to the greatest possible extent, in actual dollar amounts or, at the least, in reasonably estimated dollar amounts.

Concluding Thoughts

The trend toward disclosure and transparency is well under way and is accelerating. Once fiduciaries are regularly receiving the additional information on fees, expenses, and revenue sharing, the expectations for fiduciary prudence will be heightened. Fiduciaries will be expected to review and evaluate the information they receive and to make informed decisions for the benefit of the participants. ■