401(K) AND 403(B) PLAN SPONSORS AND THEIR FIDUCIARY DUTIES FOR REVENUE SHARING

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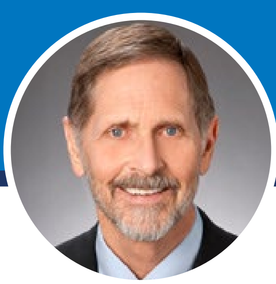
A WHITE PAPER BY



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401(K) AND 403(B) PLAN SPONSORS AND THEIR FIDUCIARY DUTIES FOR REVENUE SHARING

Introduction

The revenue sharing paid by investments in 401(k) and 403(b) plans is becoming a significant issue with the U.S. Department of Labor and the courts. As a result, the officers and managers (including committee members) of plan sponsors who serve as fiduciaries need to learn about how revenue is being paid, how it is used in their plans, and how that impacts their participants.

A few years ago, revenue sharing wasn't on the fiduciary radar screen, but now it is a basis for litigation about fiduciary breaches. As a result, The Standard has hired my law firm, Drinker Biddle & Reath, to create this educational paper to help retirement plan fiduciaries understand the revenue sharing issues and to explain steps that fiduciaries can take to ease their compliance burden and minimize their risks.

Every 401(k) and 403(b) fiduciary needs to be able to answer these questions:

- What is revenue sharing?
- How much revenue sharing is paid by my plan's investments?
- Who receives that revenue sharing and what do they do for it?
- Am I fulfilling my fiduciary responsibility for the oversight of the revenue sharing?
- Are my employees being treated fairly and legally?

Unfortunately, the inability to answer those questions could be a fiduciary breach. Fortunately, though, there are answers—and there are services to help you administer your plan's revenue sharing in a way that is fair, transparent, reasonable and prudent.

This white paper discusses the first, third and fifth of those points:

- What is revenue sharing?
- Who receives that revenue sharing and what do they do for it?
- Are my employees being treated fairly and legally?

The remaining questions are covered in the attached Legal Discussion Briefs.

Let's start with the threshold question:

What is Revenue Sharing?

Revenue sharing is an industry term rather than a legally defined phrase. But it has legal significance in the context of participant-directed plans, such as 401(k) plans and 403(b) arrangements.

In a 2013 Advisory Opinion, the U.S. Department of Labor discussed revenue sharing and described it as follows: *"[The recordkeeper] receives revenue sharing payments from these investments [that is, the 401(k) plan's investment alternatives] in the form of*

Securities and Exchange Commission Rule 12b-1 fees, shareholder and administrative services fees or similar payments."[1]

More generally, though, the term refers to any payments or credits derived from a plan's investments. In addition to the categories in the quote from the advisory opinion, it can include sub-transfer agency payments, omnibus accounting fees, and credits for proprietary products (that is, mutual funds or other plan investments that are affiliated with the recordkeeper). These are also referred to as indirect payments, since they do not come directly from the plan or the plan sponsor.

Regardless of the labels, the key point is that the payments and credits result from investments made by participants in the plan's investment lineup. So, as a practical matter, the participants are the source of the payments and they bear the cost of the payments. As a result, the money must be used for the benefit of the participants, and plan fiduciaries have the responsibility to closely monitor revenue sharing and how it is used.

Revenue sharing is usually paid to a plan's recordkeeper. The recordkeeper then applies the money to pay the recordkeeper's fee, giving the appearance that the plan is "free" or, at the least, low priced. However, it's not free; instead, the money comes from the expense ratios of the plan's investments. For participant-directed plans, some providers disclose revenue sharing to plan participants and the fee disclosure might look something like this:

Fund Name	***Mutual Fund Fees & Expenses***	***Revenue Sharing***
Stable Asset Fund	0.81%	0.23%
Balanced Index	0.08%	0.00%
Income and Growth Fund	0.84%	0.48%
Small Cap Fund	1.01%	0.38%
International Fund	1.17%	0.38%

If all of a plan's investments paid the same revenue sharing, the costs of running the plan would be shared equitably, or proportionately, by the participants, in the sense that the revenue sharing generated from the investments would be the same percent of each participant's account. However, that's generally not the case. As shown above, plans usually have investments with materially different expense ratios and with investments that generate significantly different revenue sharing. As a result, participants who invest in the more expensive options often pay more of the cost of the plan than participants who invest in less expensive options. That raises the question, why should some participants be charged proportionately more for being in the plan than others? Many plan sponsors find that to be unfair. Even worse, it raises issues of whether the plan fiduciaries are making prudent decisions.

With that understanding of revenue sharing, the next question is:

1. DOL Advisory Opinion 2013-03A.

Who Receives That Revenue Sharing and What Do They Do for It?

Fiduciaries must know who is receiving the revenue sharing and what are they doing in return for the money.

In the typical case, the revenue sharing is being paid by the investments (and investment managers) to the recordkeeper for a 401(k) or 403(b) plan. And, in those cases, the money is part of the compensation of the recordkeeper for its services to the plan and the participants.

Those services can include keeping track of the shares of the mutual funds owned by each plan and allocated to each participant's account, distributing mutual fund prospectuses, providing other information about the investments to the participants and plan sponsors, executing transactions for the participants with the mutual funds, and so on. There is nothing inherently wrong with the payment of revenue sharing for those purposes.

However, from the DOL's perspective, those indirect payments to the recordkeeper are compensation to the recordkeeper and that compensation must be reasonable. In fact, if the payments are excessive, the fiduciaries have the duty to make sure that any excessive amounts are restored to the plan.

As explained by the DOL in a 1997 Advisory Opinion:

> *". . . the responsible Plan fiduciaries must assure that the compensation paid directly or **indirectly** by the Plan to [the service provider] is reasonable, taking into account the services provided to the Plan as well as any **other fees or compensation received by [the service provider] in connection with the investment of Plan assets."***
>
> *". . . The responsible Plan fiduciaries therefore must obtain sufficient information regarding any fees or other compensation that [the service provider] receives with respect to the Plan's investments . . . to make an informed decision whether [the service provider's] compensation for services is no more than reasonable."*[2] [Emphasis added.]

As a result, plan fiduciaries must know who is receiving the revenue sharing (usually, the recordkeeper) and whether the payments are reasonable for the resulting services. Plan fiduciaries should also review how revenue sharing is used. Is it retained by the recordkeeper in addition to an asset-based charge? Is the revenue sharing used as a fee offset for the recordkeeper's asset-based charges?

When the revenue sharing is equalized by returning all of it to the accounts of the participants whose investments generated the payments, the fiduciaries' job is easier, since those indirect payments are no longer a part of the recordkeeper's compensation. In this case, the recordkeeper's fee would not be paid out of the revenue sharing but instead would be paid from the plan in a clear and transparent manner. Instead, the analysis is reduced to the question of whether the recordkeeper's stated fee is reasonable for the services it is rendering.

2 DOL Advisory Opinion 97-15A.

Are My Employees Being Treated Fairly and Legally?

Once plan sponsors and fiduciaries have calculated the revenue sharing paid by the investments, and the impact of un-level revenue sharing on the participants, the fiduciaries can determine whether the arrangement is fair. "Fair" is not a fiduciary decision; instead, it is a judgment for plan sponsors. (However, as a word of warning, circumstances in which participants are not treated fairly are often the basis for fiduciary litigation.)

On the other hand, fiduciaries—such as committee members—are legally required to make prudent decisions about the revenue sharing payments and how they are used. For example, the DOL has said:

> *"It is the view of the Department that the responsible plan fiduciaries must obtain sufficient information regarding all fees and other compensation [including any revenue sharing]…with respect to the plan's investments to make an informed decision…."*[3]

When revenue sharing is received by a plan's recordkeeper, it must be understood, calculated and evaluated. As a part of that, fiduciaries must decide if (i) the amounts are reasonable and if (ii) the application of the revenue sharing among the participants is prudent. The performance of those duties requires work and information, and there are traps for the unwary if the job is not done properly. Unfortunately, there is little, if any, guidance on the legal approach for the use of revenue sharing. As a result, plan sponsors need to look to the general fiduciary rule—the prudent man rule—which requires an investigation of the payments and an understanding of the impact on the participants. Fiduciaries can also look to guidance on similar issues. For example, in one case, the DOL said that losses should be allocated to the participants who incurred the losses.[4] Applying that concept to revenue sharing, those payments would be allocated to the accounts of the participants whose investments generated the payments. That approach is called equalization of revenue sharing.

Where plan sponsors focus on the impact on participants of the payments of revenue sharing, they can negotiate with recordkeepers to equalize or levelize the revenue sharing. Those terms—equalize and levelize—are industry terms. They mean that the revenue sharing is returned to the participants whose investments paid the revenue sharing. By definition, that outcome is fair and prudent. The fairness of the allocation is because the investments that generate the most revenue sharing usually have the highest expense ratios. When the revenue sharing payments are returned to those participants, the additional costs of those investments is neutralized . . . through equalization or levelization of the revenue sharing. In other words, the fiduciaries are "safe" when they make sure that each participant is credited with the revenue sharing payments generated by that participant's investments. The safety is that all participants are charged the same amount for plan services and the true costs of the investments and the plan services are transparent.

If a recordkeeper is providing investment advice to plan fiduciaries or participants (and does not use proprietary funds), a recordkeeper can avoid conflicts of interest by paying the revenue sharing to the plan and allocating it to participants' accounts.

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3 *Id.*

4 DOL Field Assistance Bulletin 2006-01.

An equitable method of allocating those payments is equalization or levelization. In that way, regardless of the recommended investments, the compensation due to the recordkeeper does not vary based on the revenue sharing payments.

Knowing that the equalization of revenue sharing can be both prudent and fair, the next question is, what other choices do fiduciaries have and what are the considerations?

» Use revenue sharing to pay providers.

A common approach is to have the recordkeeper collect the revenue sharing and apply those amounts to its fees, often offsetting all of its fees. This is a common practice in the 401(k) and 403(b) world and has not been precluded by any DOL guidance or court decisions. However, plan sponsors may prefer equalization because of its transparency, fairness and perceived safety.

While, at first blush, this may have appeal, in the sense that the recordkeeping costs are paid and the plan appears to be "free" or low cost—upon closer examination, it has problems. That is because the effect is to allocate the cost of the plan's provider to those participants who invest in the mutual funds that pay the most revenue sharing. And, to complicate matters, participants may not understand which funds generate the highest payments and, therefore, they are left unaware of the consequences of their decisions.

Assume, as a simple example, that a 401(k) plan has two participants, Harry and Sally, and that the plan has two mutual fund investments—MFA and MFB. MFA has an expense ratio of 1.25 percent per year and pays .50 percent per year in revenue sharing, while MFB costs .75 percent and does not pay any revenue sharing. If Harry invests entirely in MFA and Sally invests entirely in MFB, Harry could end up paying all of the recordkeeping costs, while Sally would not pay anything to be in the plan.

Is that fair? Few people would say so and, as a result, many plan committees have rejected that approach, instead returning revenue sharing equitably to participants and paying recordkeeping fees in other ways.

Is it prudent or legal? Unfortunately, no court has answered that question. The question is, would a fiduciary—a plan committee—that closely studies this issue and acted "solely in the interest of the participants . . . with the care, skill, prudence, and diligence" of a knowledgeable person make that decision?

While this is a common practice and there isn't any guidance prohibiting this option, some plan fiduciaries have decided that the benefits of equalization make it a superior alternative.

» Allocate the revenue sharing to the participants on a pro rata basis.

Another common approach is to allocate the revenue sharing to the participants in proportion to their account balances.

In our hypothetical, if the account balances of Harry and Sally were the same, each would have 50 percent of the assets in the plan and, therefore, under a pro rata allocation each would be entitled to 50 percent of the revenue sharing. But, could fiduciaries reasonably allocate 50 percent of the revenue sharing to Sally's account if all of those payments came from Harry's investments?

Unfortunately, there is no clear legal answer to that question.[5] As a result, plan fiduciaries need to study the situation, including the sources of the revenue sharing, and make a prudent decision about the allocation of the payments.

The pro rata allocation of revenue sharing is often used by plans and is not precluded by DOL guidance or court decisions. However, the fairness and transparency of equalization is causing an increasing number of plan sponsors to opt for that method.

Conclusion

As this discussion indicates, there is little in the way of guidance to help plan sponsors and their fiduciaries make legal and prudent decisions. Under these circumstances, the safe answer may be the fair answer. It seems difficult, if not impossible, for anyone to object to the equitable allocation of revenue sharing.

5 Note that, in Field Assistance Bulletin 2003-03, the DOL said that the pro rata allocation of plan expenses could be reasonable. However, that guidance applied to plan expenses (for, *e.g.*, recordkeeping) and not to the allocation of revenue sharing. The key difference is that revenue sharing can be traced to a particular source—the investments that made the payments.

LEGAL DISCUSSION BRIEF: HOW MUCH REVENUE SHARING IS PAID BY MY PLAN'S INVESTMENTS?

While plan fiduciaries, such as committee members, may be vaguely familiar with the revenue sharing paid by their plan's investments, ERISA's fiduciary responsibility rules require that they fully understand the payments and, in fact, that they calculate the amount of the payments.

For example, in its "friend-of-the-court" brief in the leading case of ABB v. Tussey, the Department of Labor said: *"In holding that the ABB fiduciaries violated the duty of prudence, the district court found, based on the factual record established during the trial, that ABB failed to: calculate the amount of recordkeeping that the Plans paid to [the recordkeeper] through revenue sharing."*[6]

Similarly, in Advisory Opinion 2013-03A, the DOL said: *"It is the view of the Department that the responsible plan fiduciaries must obtain sufficient information regarding all fees and other compensation [including any revenue sharing . . . with respect to the plan's investments to make an informed decision . . . ."*[7]

In other words, in order to fulfill their fiduciary responsibilities, the officers and managers who make decisions about their companies' retirement plans (and, therefore, are fiduciaries) must investigate the amount of revenue sharing being paid by each of the plan's investments, and calculate the amounts.

This is a critical responsibility, since the amounts of revenue sharing paid by investments often, and perhaps typically, is a function of the investments' expense ratios. In other words, the participants are paying for the revenue sharing, and the fiduciaries need to make sure that they are not overpaying.

In order to do that, fiduciaries must engage in a prudent process under ERISA's fiduciary rules. That rule says that fiduciaries must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and **familiar with such matters** would use . . . ."[8] [Emphasis added.]

As the highlighted language says, plan fiduciaries need to make decisions subject to the standard that they are familiar with such matters and, in this case, "such matters" are the payments of revenue sharing.

As a result, when revenue sharing is paid to, and retained by, a recordkeeper, plan fiduciaries have a duty to know about the revenue sharing, the amounts paid by each investment, and the total revenue sharing paid to the recordkeeper.

However, when the revenue sharing is equalized by returning it to the participants whose investments generated the payments, the burden of fiduciary compliance is greatly reduced.

6 United States Department of Labor, Office of the Solicitor, Amicus Brief, in the United States Court of Appeals for the Eighth Circuit, June 17, 2013.

7 Supra, at footnote 1.

8 ERISA section 404(a)(1)(B).

LEGAL DISCUSSION BRIEF: AM I FULFILLING MY FIDUCIARY RESPONSIBILITY FOR OVERSIGHT OF THE REVENUE SHARING?

In addition to the responsibilities to know and calculate the revenue sharing, and to know the recipient of those payments and the related services, plan fiduciaries have two additional duties. The first of those is the duty to determine the reasonableness of the arrangement and the second is to determine if the value of the revenue sharing to being prudently allocated among the participants. This part of the paper discusses the reasonableness issue.

Under the prudent man rule and ERISA's prohibited transactions, fiduciaries must ensure that the plan is not paying too much for the plan's investments and services.[9]

As explained by the DOL in an Advisory Opinion: *"[The] responsible plan fiduciaries must assure that the compensation the plan pays directly or indirectly to [the recordkeeper] for services is reasonable, taking into account the services provided to the plan as well as all fees or compensation received by the [the recordkeeper] in connection with the investment of plan assets, including any revenue sharing."*[10]

But, how do fiduciaries make that determination? Fortunately, one court has explained:

> *"To assess the prudence of a revenue sharing arrangement, [the plan fiduciaries] had to determine the market rate for the recordkeeping services provided to the Plan. Without such a baseline, it would be impossible to determine whether a revenue sharing arrangement would add to the value of the . . . Plan."*[11]

In other words, fiduciaries need to obtain market data (*e.g.*, from RFPs or benchmarking services) and compare that information to the total compensation being received by the plan's service providers. Keep in mind, though, that the service provider compensation includes all direct and indirect payments (*i.e.*, revenue sharing).

The fiduciary duty is to compare the total compensation (including revenue sharing) being received by the plan's service providers to objective market data.

However, if the plan equalizes revenue sharing, it is restored to the participants whose investments generated the payments . . . and, therefore, is not paid to the recordkeeper. As a result, where revenue sharing is equalized, it does not need to be evaluated as part of the recordkeeper's compensation.

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9 ERISA sections 404(a)(1)(A) and 408(b)(2).

10 Department of Labor Advisory Opinion 2013-03A.

11 *Tussey v. ABB, Inc., No.* 06-04305-CV-C-NKL (W.D. Mo. Nov. 2, 2012), vacated and remanded, 746 F.3d 327 (8th Cir. 2014).

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