ERISA Fiduciary Issues for Plan Sponsors: What Do 401(k) Plan Fiduciaries Need to Know About Revenue Sharing?

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Retirement plan revenue sharing has a bad reputation. Numerous lawsuits have been filed during the past year against employers that sponsor 401(k) plans alleging breach of fiduciary duty under the ***Employee Retirement Income Security Act of 1974 ("ERISA")*** with respect to revenue sharing generated by the plans' investments.[1] The Securities and Exchange Commission has pursued high-profile investigations of investment providers regarding their revenue sharing practices in retirement plans and otherwise. And the Department of Labor has devoted significant attention to retirement plan revenue sharing arrangements over the past several years to enforce ERISA's strict fiduciary duties of loyalty and prudence.

All that said, ERISA does not prohibit retirement plan revenue sharing or even the retention of revenue sharing payments by retirement plan service providers. So, what's the concern? What do 401(k) plan fiduciaries need to know about revenue sharing? Here are some answers.

What Is Revenue Sharing?

Revenue sharing generally refers to payments made by mutual funds to service providers ("Fund Service Providers") to compensate them for the services they provide for those funds. For example, a mutual fund may pay sales and service fees (collectively referred to as "12b-1 fees") to a Fund Service Provider as consideration for the Fund Service Provider including the fund on the Fund Service Provider's investment platform and to provide recordkeeping, custody, and individual level accounting services for investments in the fund by the Fund Service Provider's customers. Or a mutual fund may pay a subtransfer agency fee (sometimes referred to as a "sub-TA fee") to a Fund Service Provider to execute trades in the fund and to maintain shareholder records with regard to investments in the fund by the Fund Service Provider's customers. These are all generally referred to as revenue sharing. In the case of a retirement plan's investment in a fund, the Fund Service Provider that is receiving a revenue sharing payment is often also a recordkeeper or other service provider to the plan that is investing in the fund (a "Plan Service Provider"). In that case, an entity may be both a Fund Service Provider and a Plan Service Provider. But that is not always the case; sometimes retirement plan revenue sharing payments are made to entities that have no relationship whatsoever to a retirement plan investing in the fund.

Impact on Fund Expense Ratio

Revenue -sharing payments are expenses for the mutual funds that pay them. Those expenses, like most fund administrative expenses, are reflected in the fund's expense ratio. All else being equal, a fund that pays revenue sharing will have a higher expense ratio than a fund that does not.

401(k) plan fiduciaries have an obligation under ERISA to take cost, including expense ratios, into account in evaluating the appropriateness of funds that are candidates to be included in the plan's investment lineup. As cost is only one factor that a fiduciary must take into account when evaluating funds, a fiduciary is not obligated to select lower cost funds that do not pay revenue sharing. However, as with all fiduciary decision-making, if a fiduciary selects a more expensive fund that pays revenue sharing, the fiduciary should document the rationale for the selection.

For example, the higher cost may be justified by reasonably anticipated superior performance. Alternatively, the entity receiving the revenue sharing may be the plan's recordkeeper (which is acting both as Fund Service Provider and Plan Service Provider) and the revenue sharing is used to pay all or part of the plan recordkeeper's compensation for providing services to the plan. In that case, the cost of the revenue sharing to the plan, reflected in the fund's expense ratio, is offset by a reduction in the recordkeeping expenses that the plan must pay to the recordkeeper directly.

Recent lawsuits filed by employees have suggested that plans with sufficient bargaining power due to the amount of assets to invest may have a duty to leverage that bargaining power to negotiate for less expensive funds, including, for example, by investing in share classes with lower expense ratios. Plan fiduciaries should generally document all of their efforts to reduce plan fees, including efforts to negotiate for less expensive share classes. This may be particularly important where differences in share classes are attributable to revenue sharing that is paid to third parties (and not to a Plan Service Provider), as such reductions can directly benefit the plan. (Where revenue sharing is paid to a Plan Service Provider, a reduction in fees through investment in less expensive share classes that pay less revenue sharing may simply increase the direct fees payable to the Plan Service Provider resulting in no net gain to the plan.)

The Excessive Compensation Issue

ERISA plan fiduciaries are obligated under ERISA to ensure that the total amount of compensation paid to a Plan Service Provider for its service to a plan is reasonable and not excessive. Both the federal courts and the U.S. Department of Labor take the position that if a Plan Service Provider receives revenue sharing payments attributable to a plan's investment in a fund, then the Plan Service Provider's compensation for plan-related services includes those revenue sharing payments. [2] Accordingly, the plan fiduciaries have an obligation under ERISA to understand and monitor revenue sharing payments made to a Plan Service Provider to ensure that the total amount of such payments, together with any other sources of compensation received by the Plan Service Provider (e.g., direct payments of fees by the plan, float, etc.) are not excessive.

Here's a simplified example. Assume that a plan has 1,000 participants and that the plan fiduciary determines (based upon an evaluation of the market and total expenses paid for recordkeeping services by peer plans) that a reasonable fee for recordkeeping services is $35 per participant per year, or a total of $35,000. The plan recordkeeper charges the plan $10 per participant per year for its services, or $10,000 per year. In addition, the recordkeeper collects revenue sharing payments from the funds in which the plan invests through the recordkeeper's platform. If the total amount of revenue sharing payments collected by the recordkeeper for a year is $50,000, the total compensation received by the recordkeeper for that year is $60,000 ($50,000 of revenue sharing payments plus $10,000 of direct fees paid by the plan)--an amount in excess of the $35,000 determined by the plan's fiduciaries to be a reasonable amount of compensation. This plan fiduciary would likely be viewed as having breached its fiduciary duty under ERISA by allowing the recordkeeper to receive $25,000 of excessive compensation.

Plan fiduciaries can avoid this result in a variety of different ways:

- Recapture Revenue Sharing. Recapture is one of the most common methods for avoiding excessive compensation through revenue sharing. In this alternative, the plan recaptures either all revenue sharing so that all revenue sharing is paid to the plan ("complete recapture"), or the plan recaptures only excess revenue sharing so that any revenue sharing payments that would cause the Plan Service Provider's total compensation to exceed the reasonable compensation threshold are paid to the plan ("partial recapture").

  In the example above, under the complete recapture alternative, the plan could completely recapture the $50,000 of revenue sharing payments to the recordkeeper. Of course, the recordkeeper will presumably not provide $35,000 of services for only the $10,000 per participant fee. So, the plan fiduciaries and the recordkeeper would negotiate to make up the difference through some other source. The most obvious solution would be to increase the per participant fee paid directly by the plan to $35. Under the partial recapture alternative, the plan would pay the recordkeeper $10 per participant ($10,000 of total direct fee payments) and the recordkeeper would retain $25,000 of revenue sharing payments. The remaining $25,000 of revenue sharing would be recaptured by the plan. Either way, the total compensation received by the recordkeeper is $35,000.

  Recaptured revenue sharing payments (whether complete or partial) can be structured in a couple of different ways. The most direct structure is for the plan fiduciaries to cause recaptured revenue sharing to be paid to the plan. Alternatively, recordkeepers can retain recaptured revenue sharing and record the recaptured amounts in a bookkeeping account. These are often called "ERISA accounts." The recordkeeper is then directed by plan fiduciaries regarding the expenditure of ERISA account balances for the benefit of the plan--typically, they are used to pay for plan expenses, which may include any direct payments that the plan owes to the recordkeeper. [3]

- Eliminate Revenue Sharing. Perhaps the most direct way to avoid excessive compensation through revenue sharing is to simply avoid funds that pay revenue sharing so that there is no revenue sharing to be monitored and all compensation is made through other sources (e.g., directly by the plan). However, that may not always be the best result. In some cases a plan may pay less by allowing a recordkeeper to be paid through revenue sharing (i.e., the expense paid through a higher expense ratio attributable to the revenue sharing may be smaller than the expense that would have been paid directly). In the example above (where the plan invests in a fund array that generates $50,000 of revenue sharing against $35,000 of reasonable compensation and $10,000 of direct plan payments--we'll call this "Fund Array 1"), assume that the overall expense ratio of Fund Array 1 is 0.75% and that a comparable fund array that does not pay revenue sharing ("Fund Array 2") has an overall expense ratio of 0.45%. If the plan has $10,000,000 of assets, the investment in Fund Array 1 would generate $75,000 of fund expenses and the investment in Fund Array 2 would generate $45,000 of fund expenses. The total net expense to the plan would be as follows:

	Fund Array 1	Fund Array 2
Total Fund Expense	$75,000	$45,000
Total Direct Payments to Recordkeeper	$10,000	$35,000
Excess Revenue Sharing Recaptured by Plan		
Net Expense to Plan	$60,000	$80,000

In this example, the elimination of revenue sharing by switching to Fund Array 2 would cause the plan to incur $20,000 more total expense. The facts could work the other way as well. If Fund Array 2 has an overall expense ratio of 0.20%, then Fund Array 2 would have less overall cost:

	Fund Array 1	Fund Array 2
Total Fund Expense	$75,000	$20,000
Total Direct Payments to Recordkeeper	$10,000	$35,000
Excess Revenue Sharing Recaptured by Plan		$0
Net Expense to Plan	$60,000	$55,000

Of course, these are oversimplified examples. In reality, plan fiduciaries will select a broad array of funds to provide for proper diversification opportunities for plan participants some of which may pay revenue sharing and some of which may not. Plan fiduciaries will need to evaluate revenue sharing arrangements and expenses in aggregate across all fund options to properly assess cost impact to the plan.

A significant advantage of a plan's investing in funds that do not pay revenue sharing is that it eliminates revenue sharing altogether and, therefore, eliminates the fiduciary's obligation to monitor it. It is not easy to monitor revenue sharing. While Plan Service Providers are generally obligated to disclose revenue sharing arrangements to plan fiduciaries under U.S. Department of Labor regulations (see DOL Regulation § 2550.408b-2(c)), they typically only make a general disclosure of the revenue sharing arrangement, and plan fiduciaries do not normally receive a detailed accounting of the actual amounts of revenue sharing being paid to the Plan Service Provider. That puts most plan fiduciaries in the position of having to estimate revenue sharing, which creates risk if the estimate is wrong.

That risk is exacerbated by the fact that revenue sharing is generally based upon total assets invested and, therefore, tends to increase over time as plan assets appreciate and additional contributions are made. At the same time, the amount of services provided by the plan's recordkeeper (and thus the compensation that may reasonably be paid to the recordkeeper) tends to vary based upon the number of participants, not on total assets. Where revenue sharing is used to compensate a recordkeeper, this means that increases in the recordkeeper's actual compensation may outpace increases in the amount of compensation that may reasonably be paid. This sort of asset-based compensation framework places even greater pressure on plan fiduciaries to monitor revenue sharing to ensure that what once may have been reasonable has not become unreasonable.

The trend toward non-platform open architecture, where the menu of fund choices available to the plan fiduciary is not restricted and funds do not pay revenue sharing for inclusion on the recordkeeper's platform, is in substantial part a reaction to these general concerns over the difficulty of monitoring revenue sharing.

The Allocation Fairness Issue

Generally, the cost of recordkeeping services varies based upon the total number of participants in a plan. For that reason, plan fiduciaries generally try to allocate the cost of recordkeeping services among all plan participants uniformly so that each participant bears the same amount of recordkeeping cost regardless of the size of the participant's account balance and regardless of the funds in which the participant invests.

Revenue sharing arrangements interfere with that objective. To the extent revenue sharing is retained by the plan recordkeeper as partial or full payment of its compensation for providing recordkeeping services, recordkeeping fees are borne disproportionately by the participants who invest in the funds that pay disproportionately greater amounts of revenue sharing (because the funds' revenue sharing expense is charged to the funds and reflected in higher expense ratios for those funds).

Even if the revenue sharing is recaptured by the plan, a question arises as to how the recaptured funds are used. If used to pay plan expenses that would or should otherwise be borne equally by all plan participants--such as direct payments owed to the recordkeeper or plan auditor expenses--the participants who invest in the revenue sharing funds are still effectively paying a disproportionate share of those expenses.

Some plan fiduciaries attempt to allocate recaptured revenue sharing back to participants who invested in the funds that generated the revenue sharing. However, that process can be difficult for many plan recordkeepers. Moreover, it raises difficult questions about how that allocation should be done as participants move in and out of funds at different times and in different amounts, and some participants who invested in funds that generated revenue sharing may no longer be participants in the plan. It is difficult, if not impossible, to directly attribute specific revenue sharing payments to specific investment dollars.

The Department of Labor has not addressed the allocation of revenue sharing directly. However, the guidance it has provided in related contexts (the allocation of expenses and the allocation of certain expense reimbursements and revenue streams such as class action settlement recoveries and insurance demutualization proceeds) suggests that plan fiduciaries have a duty under ERISA to consider the proper use of revenue sharing payments. That consideration should take into account any requirements in the plan document as well as a balancing of the competing interests of various groups of plan participants with respect to those payments. If possible, allocations of those payments should be done in a manner that benefits the participants who paid for the revenue sharing through their investments in more expensive funds.

That does not mean that a plan fiduciary must allocate revenue sharing to those participants. Rather, it means that the fiduciary should engage in a process of determining whether it is practicable to do so based upon the complexities of such an allocation and the costs associated with determining such allocations. A fiduciary might reasonably determine that the cost and complexity associated with such an allocation would exceed the benefit gained by the plan through revenue sharing. As with all fiduciary decision-making activity, the goal is not necessarily to show that the fiduciary made the "right" decision. Rather, it is to show that the fiduciary recognized that a fiduciary decision is required, engaged in a process of evaluating the decision (here, the question of how to use revenue sharing), and made a reasoned (and reasonable) decision on the basis of that evaluation. And of course, it is important for the fiduciary to document the evaluation, the decision, and the rationale for the decision.

The days of plan sponsors thinking that they are getting recordkeeping services "for free" because no direct payments are made to plan recordkeepers should be long gone. It was never true and still isn't. No recordkeeper provides recordkeeping services to a retirement plan for free. If no direct compensation payments are being made by the plan to the recordkeeper, the plan's fiduciaries can be sure that the recordkeeper is being compensated indirectly through some other source--almost certainly in whole or substantial part through revenue sharing.

Plan fiduciaries have a duty to make themselves aware of that revenue sharing, to evaluate how much of it there is, and to decide how it should be used for the plan's benefit. A plan fiduciary that does not engage in and document that process is vulnerable to a claim that it breached its fiduciary duty to plan participants.

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[1] See, e.g., Lorenz v. Safeway, Inc. (filed Aug. 25, 2016); Bell v. Anthem, Inc.(filed December 15, 2015); White v. Chevron Corporation (motion to dismiss granted, N.D. Cal. Aug. 29, 2016).

[2] See., e.g., Tussey v. ABB, Inc., 746 F.3d 327 (8th Cir. 2014); U.S. Department of Labor Advisory Opinion 2013-03A (July 3, 2013).

[3] The Department of Labor has concluded that a recordkeeper's retention of revenue sharing payments in a bookkeeping account for the benefit of a plan does not generally constitute a prohibited transaction when structured in the manner typically used by plans and recordkeepers. See, e.g., U.S.

Department of Labor Advisory Opinion 2013-03A (July 3, 2013).

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