401(k) Revenue Sharing Creates Employer Liability

By Sheldon M. Geller

Plan sponsors with fiduciary oversight of their organization's 401(k) plan need to understand the way in which investment management firms apply revenue sharing generated on 401(k) plan asset investments. Revenue sharing is a plan asset and thus must be managed in the best interest of the plan and for the exclusive benefit of plan participants.

Plan sponsors who are found to mismanage the distribution of revenue sharing and use plan assets to pay excessive fees are subject to personal liability and monetary sanctions. The plan sponsor is the only fiduciary who can be sued when a plan sponsor appoints a non-fiduciary service provider (such as a record keeper).

Accordingly, plan sponsors need to understand the basic principles of a plan fiduciary's duty to monitor non-fiduciary service providers and their revenue sharing arrangements. A successful plan sponsor defense to an excessive fee claim is based upon a demonstration of proper plan governance and best fiduciary practices.

What is Revenue Sharing?

The AICPA Audit & Accounting Guide for Employee Benefit Plans describes revenue sharing as an agreement between an investment manager and a custodian pursuant to which the manager agrees to share a portion of its management fees with a service organization (e.g., a record keeper) to help reduce the costs of administrative services provided to the plan sponsor, the plan, or to plan participants (January 1, 2015). These amounts, referred to as revenue sharing, include 12b-1 fees, sub-transfer agency fees, administrative servicing fees, and shareholder servicing fees credited to a bookkeeping account made a part of the general assets of the custodian.

Another form of revenue sharing arrangement is when a plan sponsor enters into a service agreement with the plan's service provider, and the revenue sharing is credited to and segregated in a custodial account (recapture account). These accounts are commonly referred to as recapture accounts plan expense accounts, ERISA spending accounts, or ERISA accounts. A custodial account is better than a record keeping entry, because a plan sponsor can control the disposition of revenue sharing and therefore avoid retention by a service provider.

Financial Statement Disclosure

The Financial Reporting Executive Committee recommends that disclosure be made if there is an expense offset arrangement, including a revenue sharing arrangement, whereby fees are netted against income. These arrangements generally consist of fees paid to a third-party service provider directly through the application of investment fee rebates. The plan's third-party investment manager can make these available.

The Department of Labor's Position

Department of Labor Advisory Opinion 2013-03A provides that an employer plan fiduciary may enter into a revenue sharing arrangement; however, he must act prudently and in the best interest of plan participants (July 3, 2013). The fiduciary must also take care to negotiate the specific formula and methodology under which revenue sharing will be credited to a plan and used to offset plan service provider fees.

Prudence requires that the employer plan fiduciary understand the formula, methodology, and revenue sharing amount payable to the plan's service provider before entering into the arrangement. Moreover, the plan fiduciary has a continuing duty to monitor fund expenses, fund performance, and service provider fees, and to make certain that these expenses and fees are reasonable. Advisory Opinion 2013-03A does not address any fiduciary issue involved in selecting investment options that include revenue sharing expenses, nor any fiduciary issue that may arise as a result of the allocation of revenue sharing among plan expenses or individual participant accounts.

The Selection of Service Providers

The most vulnerable fiduciary decision is the selection of the non-fiduciary 401(k) plan service provider. Compensation paid for commodity services, such as record keeping and trusteeship, is subject to benchmarking and may be compared to similarly situated plans.

Plan sponsors who use revenue sharing to pay record keeping and trustee services must understand how much compensation is paid for services, compare that compensation with current market compensation, and determine whether that compensation is reasonable. Many plan sponsors are not aware of the amount of income generated by revenue sharing used to pay service provider compensation, nor are they usually aware of market cost for comparable services—or whether the compensation is reasonable.

Revenue sharing based fees are asset based and therefore automatically increase as plan assets increase. Courts have ruled that revenue sharing based compensation far exceeds the market value for record keeping, trustee, and other administrative services.

Plan fiduciaries must engage in a periodic review of 401(k) plan service performance, competence, suitability, and compensation. Case law suggests triennial benchmarking; however, the author recommends an annual determination of compensation paid with plan assets and the reasonableness thereof.

Fiduciary Liability for Employers

Liability is driven by the asset-based compensation paid to record keepers, the compensation's automatic increases, and situations in which this compensation is no longer reasonable. Bull markets significantly increase plan assets; therefore they significantly increase asset-based compensation, even though no additional record keeping services were rendered.

Both ERISA and the common law of trusts require that plan sponsors maintain a well-documented process to support plan fiduciary decision-making. Therefore, plan committee governance must include a determination of compensation paid with plan assets and whether compensation is reasonable. Plan sponsors may not be equipped to perform these determinations, and their non-fiduciary advisors may be unable to help them.

Many advisors receive asset-based compensation offset with revenue sharing and thus have an interest in higher revenue sharing generation. Plan sponsors—not advisors—are required to use plan assets to pay reasonable compensation. These advisors are not subject to the duty of loyalty, which would otherwise require that they act in the best interest of plan participants.

Conflicted advisors and non-fiduciary service providers can create plan sponsor liability if plan committees do not benchmark compensation and negotiate reductions. Committee meeting minutes need to memorialize the process by which plan sponsors monitor compensation and determine that compensation is reasonable.

Advisors who are not fiduciaries and receive variable compensation may have to justify their choice of retail share classes. It is becoming increasingly difficult for plan committees to select retail classes over institutional ones, and provide a compelling reason for doing so. Indeed, many investment firms are purging high-expense share classes from fiduciary accounts.

Appointing an Independent Named Fiduciary

Plan sponsors may appoint a named fiduciary to determine the amount of compensation paid with plan assets in order to benchmark compensation and to assume responsibility for reasonableness. Recent case law clarifies that large plan sponsors should use institutional share classes and will need to justify the use of higher-expense retail mutual funds.

Applying revenue sharing to the payment of record keeper compensation and broker commissions is an acceptable industry practice. ERISA does not prohibit revenue sharing nor specify how allocations should be made. The Department of Labor has not provided guidance on the allocation of revenue sharing.

The author is concerned that some mutual funds pay revenue sharing to offset plan costs while other funds and self-directed accounts do not. This methodology would benefit certain participants to the detriment of others and cause an unequal allocation of fees, possibly creating liability for the plan sponsor.

Simply put, 401(k) plan sponsors using mutual funds that contain 12b-1 fees and revenue sharing expose themselves to greater fiduciary liability. Moreover, many service providers retain all revenue sharing, even if revenue sharing exceeds their fee arrangement. Retaining excess revenue sharing means that the plan sponsor is overpaying for services and is evidence of a breach of fiduciary duty.

Scrutinize Plan Sponsors

A recent Supreme Court decision makes it abundantly clear that plan sponsors need to scrutinize their current 401(k) plan investments and that the statute of limitations does not bar a lawsuit alleging inappropriate plan asset investment (see *Tibble v. Edison International*). ERISA and trust law require plan fiduciaries to conduct investment reviews regularly contingent on the circumstances.

Plan sponsors may retain an independent named fiduciary whose compensation is paid with plan assets to assume fiduciary responsibility for plan investment and plan administration. Such a named fiduciary would therefore 1) monitor service provider compensation, deliverables, and performance; 2) monitor plan asset investment expenses and performance; 3) make certain the appropriate share class is utilized; 4) negotiate service provider compensation based upon the plan's facts and circumstances; 5) conduct committee meetings and report to employer plan fiduciaries; and 6) manage the plan governance process. ❑

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