January 2014

The Fiduciary Duties for Revenue Sharing

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This article discusses the obligations of fiduciaries to understand revenue sharing and to prudently allocate revenue sharing and expenses in participant-directed plans.

Introduction

Revenue sharing may be paid out of the fund’s expense ratio, or by the fund’s investment manager, distribution company, or its transfer agent. Regardless of the source, the payment is a reflection of the fact that, when a recordkeeper makes the fund available on its platform, much of the burden to provide shareholder services and maintain share ownership records are transferred to the recordkeeper.

Revenue sharing related to shareholder services and record maintenance is sourced, directly or indirectly, in the mutual fund. This means that the participants who invest in that mutual fund bear much or all of the expense of those payments.

For most plans, revenue sharing is used to pay some or all of the plan’s recordkeeping and administrative costs. Under ERISA, the decisions about whether to select funds that pay revenue sharing and about how to pay for recordkeeping services are fiduciary decisions—and those decisions must be made prudently.

COMMENT FOR fi360: The amount of revenue sharing often varies from fund to fund. Some plan investments—including company stock investments, self-directed brokerage accounts, and some mutual fund share classes—don’t pay any revenue sharing. Thus, participants whose investments make higher revenue sharing payments may be viewed as subsidizing administrative costs for participants who have invested in a way that generates little or no revenue sharing.

Discussion

In managing participant-directed plans, such as 401(k) and 403(b) plans, ERISA fiduciaries face two important issues:

- allocating plan expenses; and
- allocating revenue sharing payments.

Plan Expenses. Expenses for administrative services to a plan are usually charged to participants in one of three ways. In each case, fiduciaries must engage in a prudent process and determine whether the method is appropriate.

1. The most common method is for recordkeepers to collect the revenue sharing and keep those amounts as payments for their fees. Arguably, that has the effect of allocating the administrative expenses on a pro rata basis (that is, in proportion to the account balances) since, if the plan had paid the fees explicitly, it would most likely have allocated the payment to participants on a pro rata basis.
2. Another method is that those expenses may be explicitly charged pro rata—each participant pays a fee based on the size of his or her account. For example, if a recordkeeper’s fee is 25 basis points (.25%), each participant’s account would be charged 25 basis points. This method is fairly common where revenue sharing is not used to pay recordkeeping costs.

3. A third possibility is that expenses could be charged per capita—each participant pays a flat dollar amount regardless of account size.

**Revenue Sharing.** Similarly, revenue sharing may, as a practical matter, be “allocated” in several ways:

1. It could be retained by the recordkeeper to pay for recordkeeping costs—which, as explained above, could be considered the equivalent of a pro rata allocation, based on account balances.

2. It could be explicitly allocated pro rata to the accounts of participants who invest in the plan’s mutual funds.

3. It could be specifically allocated to the accounts of the participants who held the mutual funds that generated the revenue sharing. In other words, the revenue sharing of each fund could be returned to the holders of that particular fund. (This method is referred to as “levelizing” or “equalizing” revenue sharing.)

The decisions about revenue sharing and plan expenses are fiduciary decisions, and these should be made through a prudent decision making process and documented in the plan records.

**Analysis and Discussion**

Neither ERISA nor court decisions require that any particular method be used for allocating revenue sharing or expenses. That being said, revenue sharing raises fiduciary questions such as, should funds that offer revenue sharing be included in the plan’s investment fund line-up, how should revenue sharing be used, and how should it be allocated?

Although the DOL has acknowledged the existence of revenue sharing and informally stated that there is nothing improper or imprudent about it from an ERISA perspective, the DOL has yet to issue guidance about the fiduciary considerations related to revenue sharing. In fact, in Advisory Opinion 2013-03A (which addresses the status of certain revenue sharing payments a recordkeeper receives from third parties), the DOL noted:

> [T]his letter does not address, any fiduciary issues involved in selecting investment options that include revenue sharing expenses versus those that do not. This letter also does not address any fiduciary issues that may arise from the allocation of revenue sharing among plan expenses or individual participant accounts or where the employer has the obligation to pay plan expenses.

Some plan documents specify how revenue sharing should be utilized. In that case, fiduciaries have the duty to follow the terms of the plan unless it would be imprudent to do so. As a practical matter, following the terms of the plan provides fiduciaries with protection tantamount to a presumption that they acted appropriately. (In egregious situations, however, the fiduciaries would be expected to use their discretion, notwithstanding such a provision in the plan documents.) If the plan does not specify how to use revenue sharing, fiduciaries must make a prudent decision about the allocation.

**Revenue Sharing Allocation**

As explained earlier, a common method of allocating expenses and revenue sharing is for a recordkeeper to collect the revenue sharing and offset those amounts against its fee. For example, a recordkeeper may charge 25 basis points, but rather than collecting from the plan, the recordkeeper offsets its fee by the amount of revenue sharing that it receives. As a practical matter, this could be viewed as a pro rata allocation of the revenue sharing; and, those participants who invest in funds that pay revenue sharing could be seen as subsidizing the fees for the participants who invest in funds with little or no revenue sharing. The DOL has not indicated that this approach is inherently right or wrong.

Another approach to allocating administrative expenses is on a pro rata basis, based on account balances—by charging each participant account with his or her proportionate share of the cost. In that case, revenue sharing payments could be allocated to the accounts of participants who invested in funds that make those revenue sharing payments. For example, if the recordkeeping fee is allocated pro rata, each participant has a recordkeeping fee of 25 basis points deducted from his or her account. Then, if a fund pays revenue sharing of 15 basis points, that amount is credited to those participants invested in that fund. Thus, if a participant was invested entirely in that one fund, he or she would pay a net recordkeeping fee of 10 basis points. On the other hand, a participant invested entirely in a fund that paid no revenue sharing would pay a recordkeeping fee of 25 basis points, and a participant who invested entirely in a fund paying 35 basis points of revenue sharing would receive a “credit” of 10 basis points.
While fiduciaries have the obligation to act prudently when deciding how to allocate revenue sharing, as discussed above, there is no explicit guidance on how to make that decision. There is, however, some DOL guidance that may, by analogy, provide a useful guide for fiduciaries.

**DOL Field Assistance Bulletin (“FAB”) 2003-03**

Revenue sharing may be considered a “negative expense” as it could be viewed as a re-payment (or reimbursement) of investment expenses that were charged to the investments. Therefore, the DOL’s guidance on allocating expenses may be viewed as analogous.

**COMMENT FOR fi360**: For example, a mutual fund may charge an expense ratio of 80 basis points, which reduces the value of participants’ investments. The mutual fund, or an affiliate, then makes revenue sharing payments to the plan of 15 basis points—hence the revenue sharing may be viewed as a return of part of the expense charged to the investment.

The first step for the fiduciaries is to consider what the plan document provides. If the plan document provides a method for allocating expenses, the fiduciaries must follow that method unless it is imprudent to do so. That being said, plan documents generally do not provide details regarding plan expenses. If the plan document is silent or ambiguous, the fiduciaries must act prudently in deciding on the method of allocation. The failure to make a decision is a decision made by default without analysis and, therefore, is a failure to engage in a prudent process.

In FAB 2003-03, the DOL said:

> 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 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.

> 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.

Thus, prudent consideration of allocating expenses (and, most likely, revenue sharing) involves two main principles:

- Consider the interests of different classes of participants; and
- Consider how the method of allocation affects each such class.

With this in mind, the fiduciaries should consider how allocating fees affects different classes of participants. For example, do the expenses benefit the participants in proportion to their account balances or do they benefit each participant equally? Fiduciaries are given wide latitude to consider factors and make decisions; the key is that they engage in a process to consider the issues . . . and then make a rational decision in light of that evaluation.

Similarly, when applying these principles to the allocation of revenue sharing, fiduciaries should weigh the interests of participants who invest in funds with higher revenue sharing payments relative to those who invest in non- or lower-revenue sharing funds. For example, brokerage accounts and company stock funds typically do not generate revenue sharing. As a result, if revenue sharing is used to offset the recordkeeping costs, then those participants who invest in the company stock or other non-revenue sharing fund may not bear any of the plan’s recordkeeping cost, but benefit from the services. However, the fact that a decision favors one group of participants over another does not necessarily mean it is imprudent. The fiduciaries must, after reviewing the facts and circumstances, determine whether it makes sense to allocate the revenue sharing pro rata even if some funds could be viewed as subsidizing others.

If a plan’s investment structure consists only of mutual funds, but the funds pay varying levels of revenue sharing, the fiduciaries must consider whether the revenue sharing should be levelized or equalized, or whether a pro rata method would be prudent. The issue is whether it is appropriate for some participants to receive more revenue sharing than their investments generated, while others receive less.

When considering an allocation method for expenses, the DOL also noted in FAB 2003-03 that conflicts of interest should be avoided:

> Further, in the case where the fiduciary is also a plan participant, the selection of the method of allocation may raise issues under the prohibited transaction provisions of section 406 of ERISA where the benefit to the fiduciary is more than incidental.
This prohibits fiduciaries (e.g., committee members) from using plan assets to benefit themselves. For example, if a fiduciary participates in the selection of the plan’s investment alternatives and then invests his own account in funds that do not make revenue sharing payments, the failure to consider a levelized allocation could be viewed as a prohibited transaction. That is, if some funds pay the recordkeeping fees, but the fiduciaries invest in other lower-cost funds, the fiduciaries could be viewed as acting for their own best interest and not that of the plan participants.

**Field Assistance Bulletin 2006-01**

In another analogous situation, the DOL considered the allocation of settlement proceeds from litigation about late trading and market timing. As pointed out earlier, revenue sharing could be viewed as recouping expenses from the investments, which is similar to recovering losses paid as a result of market timing and late trading. In FAB 2006-01, the DOL stated:

> Prudence in such instances, at a minimum, would require a process by which the fiduciary chooses a methodology where the proceeds of the settlement would be allocated, where possible, to the affected participants in relation to the impact the market timing and late trading activities may have had on the particular account. (Emphasis added.)

This says that fiduciaries should consider allocating the settlement proceeds to the participants who suffered the loss. Applying this principle by analogy, fiduciaries should consider allocating revenue sharing to the participants invested in the funds that generated the revenue sharing – i.e., levelizing.

**Conclusion**

The DOL has yet to issue guidance on how revenue sharing should be administered, other than to indicate that it is a fiduciary decision that must be made prudently. That means fiduciaries need to consider whether to select funds that pay revenue sharing, how to utilize the revenue sharing and how to allocate the revenue sharing. Here are key questions for fiduciaries to consider in making those decisions:

- What does the plan document provide, if anything, regarding revenue sharing?
- Is there a more appropriate share class (e.g., with lower cost and revenue sharing) in each fund for the plan?
- How much revenue sharing is needed for the plan’s expenses? Should revenue sharing be eliminated by selecting lower cost funds, and the recordkeeping expenses paid from participant accounts?
- How are expenses allocated among participants? How does allocation affect different classes of participants?
- How should the revenue sharing be used?
- How will revenue sharing be allocated? How will allocation affect different classes of participants?

It is critical that fiduciaries understand revenue sharing, know the amounts of revenue sharing being paid, and consider how the revenue sharing will be used and allocated. Without knowing those facts, it will be difficult for fiduciaries to make prudent decisions.