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Employee Benefits

Revenue Sharing: Risks, Rewards, and Reality for Plan Fiduciaries

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Practically all companies that sponsor a 401(k) plan hire a third party to administer and recordkeep their plan. These third party administrators, or "TPAs," offer different kinds of service packages. The most commonly used is the "bundled service arrangement" under which a TPA provides a variety of plan-related services for one fee. Under most bundled service arrangements, this fee is paid partially or entirely through "revenue sharing," which refers to payments made to the TPA by some of the mutual funds that are made available under the plan. Many plan sponsors prefer bundled service arrangements because they don't have to negotiate a fee for each service the TPA provides and because fees are paid through revenue sharing (i.e., fees do not have to be paid by the plan sponsor or charged directly to participant accounts).

What many plan fiduciaries, particularly fiduciaries of smaller plans, do not realize is that choosing a method for compensating a TPA is a fiduciary decision. Thus, plan fiduciaries should not simply choose revenue sharing without first going through a prudent process to evaluate all the available methods for compensating a TPA. Revenue sharing has some inherent problems and inequities and has been the subject of numerous lawsuits. Therefore, plan fiduciaries who fail to conduct a prudent evaluation significantly increase their exposure to liability. It is a complex area and should only be undertaken with experienced ERISA counsel. This column provides an overview of the most prominent issues that plan fiduciaries face when considering revenue sharing.

The Legal Landscape

Under the Employee Retirement Income Security of Act of 1974, as amended (ERISA), a plan fiduciary must act "with the care, skill, prudence,

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and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[1] This is a very high standard of conduct and requires plan fiduciaries to act like prudent experts. To satisfy this duty, when confronted with a decision, plan fiduciaries must (i) gather relevant information, (ii) analyze the information, (iii) seek expert advice, and (iv) make a well-reasoned decision based on the gathered information. Importantly, this duty also requires plan fiduciaries to consider the "circumstances then prevailing." In other words, as the world becomes more complex and facts change, a plan fiduciary is required to revisit and reconsider earlier decisions.

Another important fiduciary duty under ERISA requires fiduciaries to act for the exclusive purpose of providing retirement benefits to plan participants and to discharge their duties solely in the interest of plan participants. ERISA describes these duties as follows: "A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and: (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries."[2] Thus, plan fiduciaries, when confronted with a decision, must always place the interests of the plan participants ahead of everything else (e.g., their own interests or the plan sponsor's interests).

Finally, ERISA requires plan fiduciaries to "defray the reasonable expenses of administering the plan."[3] In other words, plan fiduciaries must be vigilant to ensure that any fees or charges paid with plan assets are reasonable.

Generally, the term "revenue sharing" refers to amounts paid to a TPA by a mutual fund's investment manager out of the fund's expense ratio. For example, if a mutual fund has an expense ratio of 40 basis points, the fund's investment manager may have an agreement to pass 10 basis points to the TPA. The reason for this payment is that when a TPA makes a fund available on its 401(k) platform, it relieves the fund manager of certain tasks for which it is normally responsible, such as maintaining shareholder records. It is important to note that not all mutual funds share revenue.

ERISA does not prohibit revenue sharing, and courts have stated that revenue sharing is not imprudent "per se."[4] However, deciding on a method for compensating a TPA is a fiduciary decision that requires plan fiduciaries to act prudently and in the best interest of plan participants. The U.S. Department of Labor explains this issue as follows:

> When the plan documents are silent or ambiguous on this issue, fiduciaries must select the method or methods for allocating plan expenses. 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. 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.[5]

The Problems with Revenue Sharing

Revenue sharing is a very common method used for compensating a 401(k) plan's TPA. There are two, often overlooked, issues with revenue sharing that fiduciaries must consider when deciding how a TPA should be compensated.

First, revenue sharing results in inequality because those participants who invest in funds that share revenue pay more to the TPA than those participants who invest in funds that do not share revenue. To illustrate, the chief executive officer of a company could have his or her entire 401(k) plan account invested in funds that do not share revenue, while his or her assistant could be invested exclusively in funds that share revenue. The result is that the assistant is subsidizing the cost of plan administration while the CEO is not.

The second issue arises when lower cost share classes are, or become, available for mutual funds that are offered under the plan. If the plan fiduciaries do not take action to move into the lower cost share classes, a plaintiff's attorney could bring a claim for breach of fiduciary duty. For example, in one case, *Tibble v. Edison International*,[6] plan fiduciaries added a new mutual fund to their plan, but failed to consider the lower cost institutional share class of the mutual fund as compared to the higher cost retail shall class. The court stated that the plan fiduciaries breached their fiduciary duties because they "have not offered any credible explanation for why the retail share classes were selected instead of the institutional share classes. In light of that, the fact that the institutional share classes offered the exact same investment at a lower fee, a prudent fiduciary acting in a like capacity would have invested in the institutional share class."

If the plan fiduciaries in *Tibble* had been able to show that they prudently evaluated the various methods for allocating plan expenses and had chosen revenue sharing based on that evaluation, they may have been able to offer a credible explanation for selecting the higher cost retail share class on the basis that the lower cost institutional share class did not share revenue. It is important to note that this credible explanation could be undercut if there was evidence that the plan fiduciaries failed to select the lower cost institutional share class simply to save the company money. For illustration, suppose that a TPA required $10,000 per year to service a plan and that entire amount was paid through revenue sharing. Institutional shares classes then became available which, if used, would drop the revenue sharing to $8,000. If plan fiduciaries failed to move to the institutional share classes to save the company $2,000, they could be seen as acting in the best interest of the company, i.e., not in the best interest of plan participants, which is a breach of fiduciary duty.

If a claim based on the failure to move into a lower cost share class is successful, plan fiduciaries would be personally liable for the difference between the performance of the higher cost share class and the performance of the lower cost share class, net of fees, over the applicable time period. In addition, in cases of breaches of fiduciary duty, the U.S. Department of Labor has the ability to assess a 20 percent penalty against the offending fiduciaries. Finally, ERISA allows for the payment of attorneys' fees and costs to the prevailing party.

Another issue with revenue sharing, but more well known, is that as plan assets increase, revenue sharing increases and, therefore, the compensation received by the TPA increases. As ERISA requires plan fiduciaries to ensure that fees paid to the TPA are reasonable, they will need to monitor on a periodic basis the total compensation received by the TPA inclusive of revenue sharing to ensure that the TPA's fees remain reasonable despite the increase in compensation. If total compensation paid to the TPA is determined by the plan fiduciaries to be excessive at any point in time, they will have to determine an appropriate course of action, such as establishing an ERISA budget account or negotiating for additional services from the TPA.

Dealing with Revenue Sharing Despite the Problems

Despite the problems with revenue sharing, a company may still have a preference for revenue sharing as the method for compensating its plan's TPA. One reason is that many companies prefer a bundled service arrangement with their TPA (as previously mentioned, such arrangements commonly use revenue sharing as the method for compensating the TPA). Another reason is that switching from revenue sharing to directly charging participant accounts for the TPA's services is a difficult thing to communicate to participants.

If a company wants to use revenue sharing as the method for compensating its TPA, it should engage in a prudent process to evaluate the various methods available for compensating a TPA and then make a well-reasoned decision. The process should show that, despite the inequalities that result from revenue sharing, the other methods of compensating a TPA (discussed below) also have some inherent inequalities. The process should also show a commitment on the part of the plan fiduciaries to pass the costs of plan administration on to plan participants to help defend against the assertion that any higher cost retail share classes available under the plan are being retained for the benefit of the plan sponsor. The minutes of the plan fiduciaries' meetings should document this process and the decision to use revenue sharing. Because of the complexities with this issue and the heightened litigation sensitivities, ERISA counsel should oversee the process and draft the minutes.

Alternatives to Revenue Sharing

Aside from revenue sharing, there are two other common methods for compensating a TPA. The first is the "fixed basis point" model. Under this model, each participant's account is charged annually a fixed percentage of assets for the TPA's services, e.g., 30 basis points. Thus, for example, if a participant has a 401(k) account balance of $100,000, he or she would be charged $300 per year. The problem with the fixed basis point model is two-fold. First, it causes participants with large account balances to pay the brunt of the TPA's fee. This may seem acceptable at first because one could assume it causes the highest paid employees to bear the brunt of the TPA's fees. However, the highest paid employees do not always maintain the largest account balances. Second, as plan assets increase because of additional contributions and/or investment earnings the compensation paid to the TPA also increases and may, therefore, eventually become unreasonable. Plan fiduciaries will need to be cognizant of this and should closely monitor the fees paid to the TPA by benchmarking them against the fees paid by similarly situated plans. If the fees do become excessive, plan fiduciaries will need to determine an appropriate course of action, such as establishing an ERISA budget account or negotiating for additional services from the TPA. Another alternative is to negotiate for a tiered basis point schedule under which the percentage of assets charged to participant accounts decreases as plan assets increase. For illustration, a tiered basis point schedule could look like this:

Plan Assets	***Basis Point Fee***
Less than $40 million	0.25% (25 basis points)
$40 million but less than $50 million	0.21% (21 basis points)
$50 million and greater	0.18% (18 basis points)

The other common method for compensating a TPA is the "fixed dollar" model. Under this model, each participant's account is charged a fixed dollar amount for the TPA's services, e.g., 25 dollars per year. The main problem with the fixed dollar method is that small account balances will be disproportionately impacted by the imposition of a fixed dollar charge.

An important point to note is that, regardless of whether the fixed basis point model or the fixed dollar model is chosen, revenue sharing will still occur (assuming the plan contains funds that share revenue). This may come as surprise to some, but the fact is that even if revenue sharing is not chosen as the method for compensating a TPA, funds that share revenue with the TPA will continue to do so. Obviously, plan fiduciaries cannot allow the TPA to retain the revenue sharing because the TPA will be receiving excessive compensation. Thus, plan fiduciaries need to work out an arrangement with their TPA under which the revenue sharing is credited back to participant accounts. The decision to credit revenue sharing back to participant accounts is a fiduciary decision and, thus, plan fiduciaries should engage in a prudent process to determine how the crediting should occur. There are basically three methods for crediting revenue sharing back to participant accounts. Under the first method, often referred to as the "per capita" method, each participant account is credited with an equal portion of the revenue sharing. For example, if a plan has 100 participants and the revenue sharing is $10,000, each participant account would be credited with $100. Under the second method, often referred to as the "pro rata" method, each participant account is credited with a pro rata portion of the revenue sharing based on the size of their account. For example, if plan assets total $1,000,000, a participant with an account balance of $100,000 would receive 1/10th of the revenue sharing and a participant with a $50,000 account balance would receive 1/20th of the revenue sharing. Under the third method, which is only available if the TPA can track the revenue sharing that is paid by each participant account, the TPA would credit the revenue sharing paid by a participant's account back to that account. For example, if a participant's account paid $100 in revenue sharing, the TPA would credit $100 back to the participant's account. If the third method is available through the TPA, it is preferred, because the first two methods can result in "winners" and "losers" (i.e., some participants will receive credit for revenue sharing that they did not pay and other will not receive credit for revenue sharing that they did pay).

Conclusion

Revenue sharing is a hot-button issue that is the subject of numerous lawsuits alleging breach of fiduciary duty. Even very small plans get sued over fiduciary breaches.[7] Accordingly, fiduciaries of plans of every size should conduct a prudent evaluation of the method by which their TPA is compensated. It does not matter if the plan sponsor has already signed up for a bundled arrangement using revenue sharing; conducting a prudent evaluation now will help mitigate exposure to liability.

Notes

1. ERISA § 404(a)(1)(B).

2. ERISA § 404(a)(1).

3. ERISA § 404(a)(1)(A)(ii).

4. *See, e.g.*, Hecker v. Deere & Co., 556 F.3d 575 (7th Cir. 2009).

5. DOL Field Assistance Bulletin No. 2003-03 (May 19, 2003).

6. 135 S. Ct. 1823 (2015).

7. *See, e.g.*, Compl. At 1, Damberg v. LaMettry's Collission, Inc., No. 16-cv-1335 (D. Minn. 2016) (No. 1) (fiduciaries of plan holding $9 million in assets were sued for allowing payment of excessive fees).