



The Equitable Allocation of Revenue Sharing to Participants

by Fred Reish

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Revenue sharing has become a “hot” issue. That includes the selection of mutual funds that pay revenue sharing, its use for paying plan expenses, and the allocation of revenue sharing to participants. The focus on those issues is largely due to class action lawsuits against large plans and the insistence of the Department of Labor (DOL) on revenue sharing disclosure.

Overview

While revenue sharing is typically paid to 401(k) and 403(b) recordkeepers for their services to mutual fund complexes – and then used by the recordkeepers to reduce their fees, there are other ways to use those payments. For example, revenue sharing could be paid back to the accounts of the participants that generated the revenue sharing. That treatment is referred to as “equitable,” “levelized,” or “concession neutrality” allocation.

While this article uses “equitable allocation” – and Paychex uses “return of concessions” – the process and the principles are the same. Regardless of the name, it is seen as transparent, conflict-free, and fair to participants. Because of these attributes, the equitable allocation of revenue sharing to participants provides protections to fiduciaries in fulfilling their 401(k) responsibilities.

While huge amounts of money are paid as revenue sharing, there is very little law on the subject. In fact, there is no guidance on the allocation of revenue sharing to participant accounts. We only know that revenue sharing must be understood and considered by plan fiduciaries (typically, plan committees) . . . and that the fiduciaries must reach prudent decisions about revenue sharing.

The first step in that process is for plan committees to consider the revenue sharing paid to, and kept by, their plan recordkeepers . . . and then to determine:

- If the recordkeeper’s total compensation is reasonable; and
- If the arrangement for the recordkeeper to keep the revenue sharing is acceptable.

For the second point – the fiduciary’s preferences about the use of revenue sharing, the three most common alternatives are:

- The revenue sharing is retained by the recordkeeper and used to pay its charges. This has the practical effect of

benefiting the participants in proportion to their account balances (that is, pro rata), since the most common way of allocating recordkeeping costs is in proportion to account balances. In other words, participants who invest in mutual funds that don’t pay revenue sharing are in the plan “for free,” while participants who invest in funds that pay revenue sharing bear the full cost of operating the plan.

- The revenue sharing is used to pay the recordkeeper’s cost, but any excess is deposited into the plan. This has the effect of allocating most of the revenue sharing pro rata. The excess could be allocated – pro rata, per capita (i.e., equal dollar amount to each account), or equitably, in other ways – as decided by the fiduciaries.
- The revenue sharing could be paid into the plan and allocated to participants; for example, it could be paid equitably, that is, paid into the accounts of participants who owned the mutual funds that generated the revenue sharing. The recordkeeping costs could be paid by the plan and charged to participant accounts, e.g., pro rata, so that all participants pay their proportional cost of the plan.

For these reasons, and as explained more fully in this article, a return of concessions approach – equitable allocation – provides material benefits and fiduciary protections to plan sponsors:

- Equitable allocations are a prudent method of allocating revenue sharing.
- Equitable allocations appear to be the “safest” method; and
- Equitable allocations are perceived by many plan sponsors as being fair and transparent.

This is an emerging issue . . . and the law is not clear. As a result, advisers need to understand the alternatives, consider the lack of legal guidance and help their plan sponsor clients make informed decisions.

This article discusses the legal issues and alternatives for allocating revenue sharing in participant-directed plans.

Definitions

Let’s start by defining key terms.

Revenue sharing. Payments made by a mutual fund, or its investment manager or affiliates, to a recordkeeper for participant-directed plans (e.g., 401(k) and 403(b) plans) for

keeping track of the ownership of the mutual fund's shares and other shareholder services. Under the securities laws, revenue-sharing payments may be called sub-transfer agency fees or shareholder servicing fees; in the retirement plan world, they are called "revenue sharing."

Source of revenue sharing. Money paid from a mutual fund's expense ratio, or by a fund's investment manager, distribution company, or transfer agent from their revenues. The payment is a reflection of the fact that, when a recordkeeper makes a fund available on its platform, the mutual fund's responsibility to provide shareholder services and to maintain share ownership records is significantly reduced. That savings is "shared" with the recordkeeper. While the revenue sharing may be paid by the mutual fund or its related entities, in a practical sense the source is the money in the mutual fund. This means that the participants who invest in the fund ultimately bear much or all of the expense.

Fiduciary Issues

For most plans, revenue sharing is used to pay some or all of the plan's recordkeeping and administrative costs. However, 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. (Since the responsible fiduciary for most mid-sized and large plans is a plan committee, this article refers to plan committees when discussing fiduciary responsibilities.)

The amount of revenue sharing varies from fund to fund. Some investments – including company stock investments and self-directed brokerage accounts, and some mutual fund share classes – make no revenue-sharing payments at all. Thus, participants whose accounts are invested in funds that pay revenue sharing are subsidizing the administrative costs for participants who have invested in the investments that pay little or no revenue sharing. That raises the obvious question of whether it is fair – or even legal – to place the financial burden of a plan on some participants . . . while others pay little or nothing for the cost of running the plan. Plan committees need to understand those facts and their consequences – and then make prudent decisions about them. (A "prudent" decision is one that is informed and reasoned. "Informed" means that the committee understood and evaluated the relevant information. "Reasoned" means that the committee reached a rational decision based on their analysis.)

The Employee Retirement Income Security Act of 1974 (ERISA) does not prohibit revenue sharing or specify how allocations should be made. But, it is clear that those are fiduciary decisions subject to ERISA's fiduciary rules. And, while there is not any specific guidance in ERISA or in court cases, the DOL has ruled on analogous issues. This article discusses that guidance.

Plan committees have some flexibility in allocating revenue sharing – so long as they engage in a prudent process. That process requires that they consider, among other things, the different methods for allocation of revenue sharing. While more than one method may be "prudent," several conclusions can be reached:

- **Equitable allocations are a prudent method of allocating revenue sharing;**
- **Equitable allocations appear to be the "safest" method; and**
- **Equitable allocations are perceived by many plan sponsors as being fair and transparent.**

However, not all recordkeepers can allocate revenue sharing in an equitable, return of concessions, manner. As a result, committees and their advisors need to be aware of the capabilities of recordkeepers when selecting providers.

Discussion

In managing participant-directed plans (such as 401(k) and 403(b) plans), committees face two important questions that are often overlooked: how to allocate plan expenses and how to allocate revenue sharing.

As a practical matter, revenue-sharing payments are often used to offset plan expenses. For example, revenue sharing is often used to reduce the fees that a recordkeeper would otherwise charge. But, it doesn't have to be that way. Revenue sharing could be deposited into a plan and allocated equitably, that is, to the accounts of participants whose investments paid the revenue sharing. And the costs of recordkeeping could be paid by the plan and allocated to the participants' accounts using, for example, a pro-rata method. Pro-rata allocation is where expenses are allocated to participant accounts in proportion to the value of the accounts.

As another alternative, the revenue sharing could be used to pay the recordkeeping costs and any revenue sharing in excess of those costs could be paid into the plan to be used to pay plan-related expenses (an "expense recapture account"). Committees need to understand those alternatives and make prudent decisions about them. As a part of that process, committees should understand

that there is no legal guidance and, therefore, that there is some risk. However, if the revenue sharing is returned to the accounts of the participants, whose mutual-fund investments generated the revenue sharing, the risk is mitigated and probably eliminated. A committee has not engaged in a prudent process if the committee members unknowingly allow the recordkeeper to make those decisions.

Fiduciary Allocation of Revenue Sharing

If the plan document specifies how revenue sharing is to be allocated, the fiduciaries have the duty to follow the terms of the plan, unless it would clearly be imprudent to do so. However, if a plan does not specify how to use revenue sharing (and most don't), then committees must make prudent decisions about the allocation.

Currently, the most common method of using revenue sharing is to pay the expenses of the recordkeeper; that is, the recordkeeper keeps the revenue sharing that it receives and reduces its fees accordingly. In most cases, recordkeeping expenses are allocated pro rata to the accounts of the participants – when they are not paid by revenue sharing. As a result, this method is equivalent to allocating the revenue sharing on a pro-rata basis to the participants.

But, do plan committees understand that, as a legal matter, they made that decision? What documentation do they have to support that they engaged in a prudent process to reach that decision?

Unfortunately, the DOL has not issued guidance on the allocation of revenue sharing. In fact, in a recent advisory opinion (2013-03A), the DOL indicated that “the allocation of revenue sharing among plan expenses or individual participant accounts” was a fiduciary issue that the Department was not addressing.

However, it has provided guidance on the allocation of plan expenses, which is analogous and, therefore, helpful in understanding the DOL's thinking. In Field Assistance Bulletin (FAB) 2003-03, the DOL said that fiduciaries can evaluate the benefit to participants and allocate in any manner (e.g., pro rata or per capita) that reasonably reflects that benefit. But, committees must engage in a process to make that decision and must take into account the impact on the participants.

In other analogous guidance, the DOL addressed the allocation of proceeds from the settlement of the late trading and market timing cases. FAB 2006-01, the DOL said:

“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.”

In this case, the DOL is saying that, where possible, the settlement money should be allocated to the accounts of the participants who had suffered losses because of to the late trading and market timing violations. While not dispositive, this supports the equitable allocation of revenue sharing – since, like allocating losses, the allocation of revenue sharing returns money to the participants that paid for the revenue sharing.

An important role for advisors is to educate committee members about these issues. The concept of revenue sharing is complex, and the amounts and sources of the payments are not obvious. Also, committee members may not be aware that some recordkeepers can provide equitable allocation of revenue sharing, while others cannot. As a result, committees are dependent on their advisors for this information . . . and for fiduciary compliance. This article should help committees understand their responsibilities.

If a committee simply accepts the allocation method used by a plan's recordkeeper, the committee will have abdicated its responsibilities. That could be a fiduciary breach. Instead, a committee should engage in a prudent process to understand the issues and to make reasonable decisions. Based on the lack of specific guidance on allocating revenue sharing, committees should consider equitable allocations – the return of concessions – because of the safety inherent in returning money to the participants who were in the mutual funds that paid the money. However, committees should not, and legally cannot, avoid consideration of these issues.

About the Author

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