Strafford

Presenting a live 90-minute webinar with interactive Q&A

ERISA Revenue Sharing Arrangements: Addressing Possible Plan Assets Status, Pursuing Due Diligence

Utilization of Excess Payments, Contract Negotiations, Allocation of Credits to Plan Participants and More

THURSDAY, AUGUST 12, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Richard K. Matta, Principal, **Groom Law Group**, Washington, D.C.

Andrew L. Oringer, Partner, **Dechert**, New York

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1**.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

Recording our programs is not permitted. However, today's participants can order a recorded version of this event at a special attendee price. Please call Customer Service at 800-926-7926 ext.1 or visit Strafford's website at www.straffordpub.com.

ERISA Revenue Sharing Arrangements: Addressing Possible Plan Assets Status, Pursuing Due Diligence

Andrew L. Oringer, *Dechert*
Richard K. Matta, *Groom Law Group*

Strafford CLE

Introduction

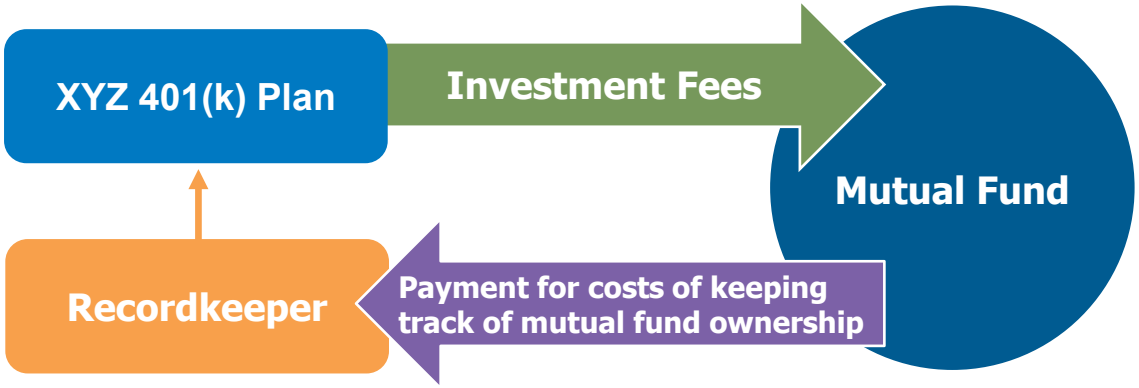
- **Confusion about revenue sharing**
  - While the courts and the Department of Labor have opined that "revenue sharing" is not *per se* impermissible, significant confusion remains regarding the use of revenue sharing in connection with the payment of plan expenses.
  - Funds, recordkeepers and other intermediaries, and plan sponsors must also keep in mind various SEC and IRS issues associated with the payment, receipt and application of revenue sharing for plan expenses.

Introduction

- **What is revenue sharing?**
  - Revenue sharing refers to the common practice of mutual funds with other investment funds paying a portion of their fees to a plan recordkeeper or other service provider to help reduce or offset recordkeeping or other administrative expenses. Sometimes the payment is routed to an unallocated "expense account" within the plan.
  - Reinsured expenses can include the costs for shareholder services (e.g., costs related to keeping track of share ownership) that would ordinarily be the responsibility of the mutual fund but are instead performed by the service provider.
  - Fees may include Rule 12b-1 "distribution" or administrative fees, shareholder services fees, sub-TA fees, or similar fees paid from the mutual fund, but also payments from the fund's investment adviser out of its own pocket.

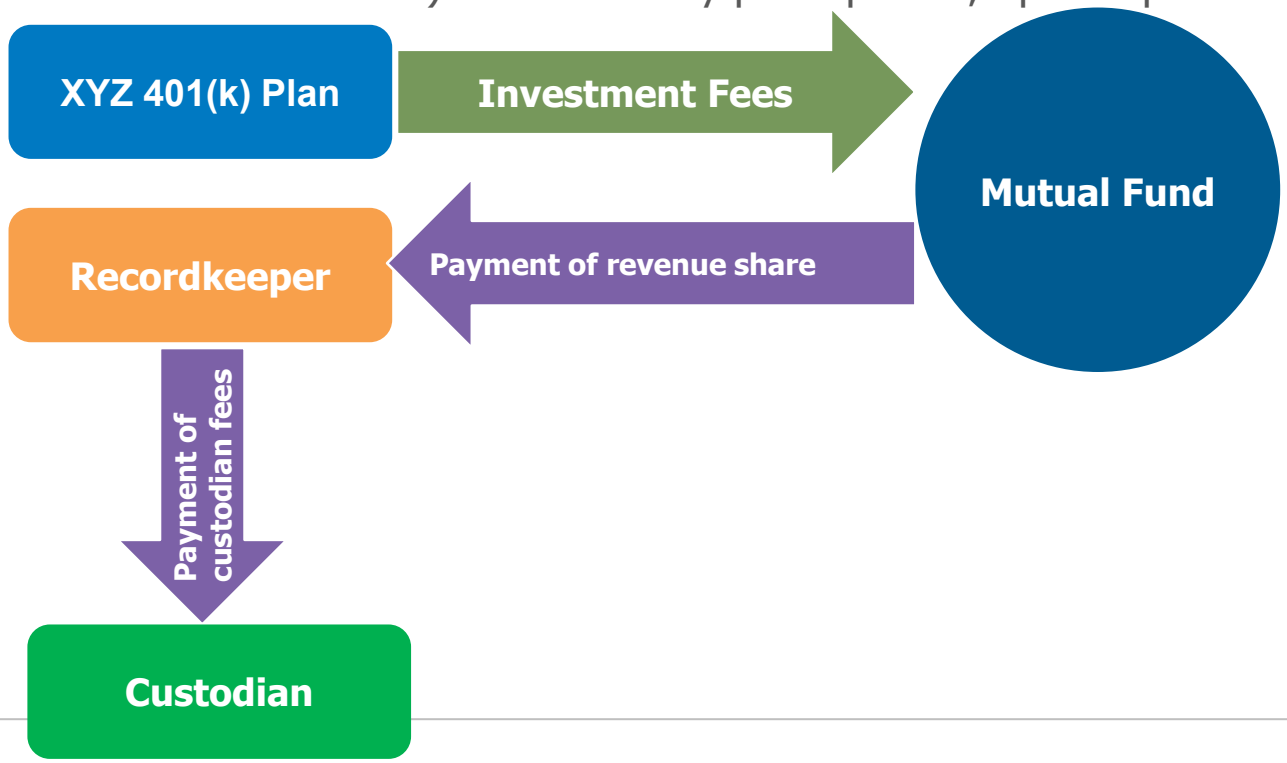
Introduction (cont'd)

- **Common revenue sharing example #1**
  - XYZ 401(k) Plan invests in Mutual Fund.
  - Mutual Fund would ordinarily be required to keep track of its ownership by itself.
  - However, since Recordkeeper services XYZ 401(k) Plan, it makes more sense for Recordkeeper to provide this service.
  - Mutual Fund makes a revenue sharing payment to Recordkeeper for administrative services.



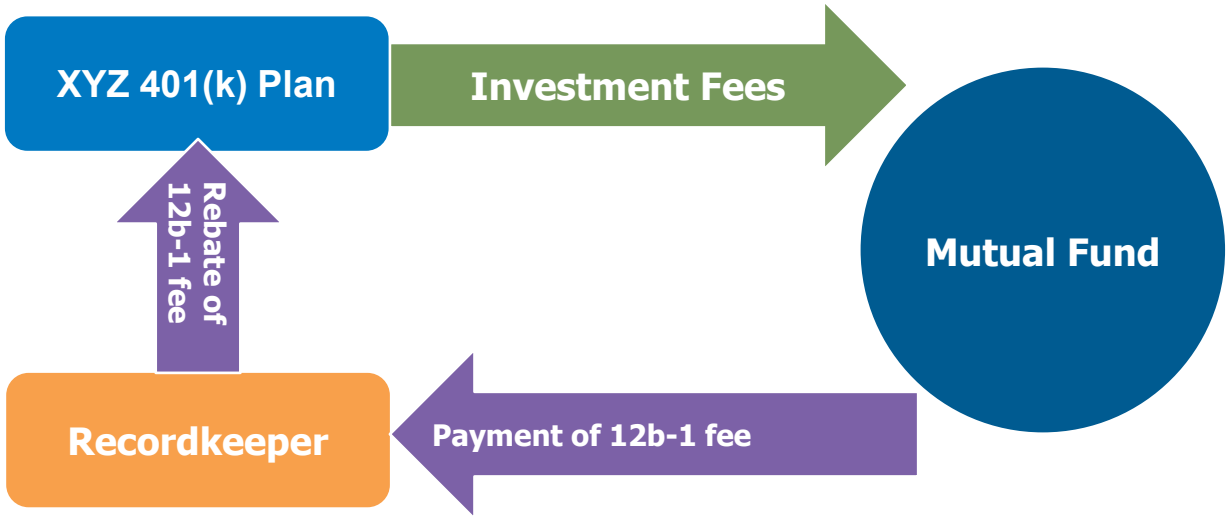
Introduction (cont'd)

- **Common revenue sharing example #2**
  - XYZ 401(k) Plan invests in Mutual Fund.
  - Mutual Fund pays revenue share to RK
  - RK keeps a portion as its fee and pays other service providers (e.g., custodian, accountant) as directed by plan sponsor, up to a pre-determined budget



Introduction (cont'd)

- **Common revenue sharing example #3**
  - XYZ 401(k) Plan invests in Mutual Fund.
  - Mutual fund pays 12b-1 fee to RK, who keeps a portion as its fee and rebates the rest to the plan to be held in an unallocated expense account to pay other expenses



ERISA Plan Assets Status

- **Common revenue sharing example #1 – no plan assets**

  – fee paid to RK by mutual fund for relieving it of responsibility for tracking participant accounts is treated by RK as compensation for plan services (408(b)(2)) and is not a plan asset

- **Common revenue sharing example #2 – maybe plan assets**

  – is the RK keeping the fee as compensation or setting it aside for the benefit of the plan?

  – commonly, the RK simply designates a nominal amount that it will pay from its own pocket as an "ERISA budget"

- **Common revenue sharing example #3 – definitely plan assets**

  – fees paid directly into the plan

ERISA's Prudence Standard

- **Revenue sharing implicates two aspects of fiduciary decision-making, both of which are subject to ERISA's prudence standard:**
  - decisions regarding plan investments
  - decisions regarding plan expenses

ERISA's Prudence Standard

- **ERISA's prudence standard is often referred to as a "prudent expert" standard, requiring a fiduciary to become familiar with all relevant considerations.**
- **Practitioners often refer to "procedural prudence," as so much of the focus of the prudence rules is on the process followed by a plan fiduciary to arrive at investment decisions.**
- **The Department of Labor has stated determining prudence is an "inherently factual question" that requires consideration of "all the facts and circumstances of the individual situation."**
- **Where a fiduciary can show familiarity with and appropriate attention to relevant considerations, and is unconflicted, it may be very difficult to attack, successfully, the fiduciary's decision using result-oriented analysis.**

ERISA's Prudence Standard (cont'd)

- **While revenue sharing is by no means *per se* imprudent, plan fiduciaries have a responsibility to be aware of revenue sharing and monitor overall provider compensation.**
- **Plan fiduciaries have an obligation to attempt to ensure that service provider compensation is reasonable.**
- **It may be appropriate for a plan fiduciary to take into account revenue sharing payments in evaluating a service provider's overall compensation, particularly in the context of shareholder services where there is a possibility that the service provider is getting paid twice for the same work.**
- **If a service provider receives "excess" compensation, whether in the form of revenue sharing or direct plan payments, the fiduciary may try to negotiate the crediting of the excess to the plan.**
  - *For example,* there may be a special expense account to offset other plan expenses.
- **ERISA also requires that plan documents be followed – it can be important to confirm that any chosen approach to revenue sharing be consistent with the governing plan documents.**

Legal Considerations

- **ERISA Fee litigation**
  - Revenue sharing arrangements have been a frequent target in 401(k) and 403(b) fee litigation.
  - Common claims include allegations that:

    (i) fiduciaries were imprudent for selecting higher cost investments with revenue sharing instead of lower cost alternatives without revenue sharing,

    (ii) the amount of the revenue sharing was not disclosed to participants, and

    (iii) service providers earned excessive compensation as a result of revenue sharing.

Legal Considerations (cont'd)

- **Setting the record straight**
  - Both the Department of Labor and the courts have recognized that revenue sharing is not *per se* impermissible under ERISA.
  - Instead, the Department and the courts continue to emphasize that the focus is on total cost, and the total fees earned by service providers.
  - Cost is not determinative but rather only one important consideration in determining the prudence of an investment.

Legal Considerations

- *Department of Labor Guidance*
  - The Department has stated that "plan fiduciaries must assure that the compensation the plan pays directly or indirectly to [the service provider] for services is reasonable, taking into account the services provided to the plan as well as all fees or compensation received by [the service provider]... *including any revenue sharing*."

    DOL Adv. Op. 2013–03A (July 3, 2013)
  - The Department has stated that plan fiduciaries have "considerable discretion in determining, as a matter of plan design or a matter of plan administration, how plan expenses will be allocated among participants

    and beneficiaries." After engaging in a prudent process, plan fiduciaries may select a method that "disfavors one class of participants, provided that a *rational basis exists* for the selected method."

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

Legal Considerations (cont'd)

- ***View of the courts***
  - "The Court is also not persuaded . . . that a flat rate would have been a more prudent way to collect fees than through revenue-sharing." "[T]he Court is not persuaded that a revenue-sharing model itself" is imprudent.

    Sacerdote v. NYU, 328 F. Supp. 3d 273, 306 (S.D.N.Y. 2018).
  - "There is nothing wrong, for ERISA purposes" with paying recordkeeping expenses through revenue sharing.

    Divane v. NW Univ., 2018 WL 2388118, at *8 (N.D. Ill. May 25, 2018)
  - "Revenue sharing arrangements are ***not per se prohibited*** under ERISA."

    Lorenz v. Safeway, Inc., 2017 WL 952883, at *13 (N.D.Cal. 2017)
  - Revenue sharing is an "'acceptable' investment industry practice[] that ***frequently inure[s]*** to the benefit of ERISA plans."

    Tussey v. ABB, Inc., 746 F.3d 327, 336 (8th Cir. 2014)

Legal Considerations (cont'd)

- *View of the courts (cont'd)*
  - The "total fee, not the internal, post-collection distribution of the fee, is the critical figure" for analyzing investment costs. "[N]othing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems)."

    Hecker v. Deere, 556 F.3d 575,586 (7th Cir. 2009).
  - "[T]he claimed industry-wide prevalence of revenue-sharing . . . does not negate the duty to ensure reasonable fees regardless of the fee structure."

    Vellali v. Yale Univ., 308 F. Supp. 3d 673, 685 (D. Conn. 2018).

Legal Considerations (cont'd)

- *Tax Law Considerations*
  - **Unallocated plan expense account.** The Code does not authorize forfeiture suspense accounts to hold unallocated monies beyond the plan year in which they arise. Specifically, Revenue Ruling 80-155 states that a defined contribution plan will not be qualified unless all funds are allocated to participants' accounts in accordance with a definite formula defined in the plan. This provision precludes a plan from carrying over plan forfeitures to subsequent plan years, as doing so would defy the rule requiring all monies in a defined contribution plan to be allocated annually to plan participants.
    - Many plans maintain unallocated revenue share expense accounts indefinitely – although the above requirements expressly relate only to unallocated forfeiture accounts, query whether the rationale for allocating remains the same?
  - **Possible discrimination issue.** Not all investments generate revenue share, nor do they do so proportionately. Aside from the fiduciary issue of whether the participants whose accounts generate revenue sharing should be the ones who benefit from it, plan fiduciaries should consider whether investments more commonly used by less highly compensated employees (e.g., QDIAs, target date funds) are generating disproportionate revenue share that is paying plan expenses that benefit the highly compensated.

Legal Considerations (cont'd)

- *Securities Law Considerations*
  - **For the mutual fund** – the Investment Company Act and SEC regulations impose various fiduciary and disclosure requirements on the fund and its board in connection with decisions regarding the offering and use of various revenue sharing arrangements.
    - Both the '40 Act and the Internal Revenue Code prohibit "preferential dividends"
  - **For the recordkeeper** – most revenue sharing payments may only be made to, and received by, registered broker-dealers or banks.
  - **For the plan and plan sponsor** – generally none. SEC no-action letters effectively permit the partial rebate of fees to the investing plan.

Possible Approaches

- **After employing a prudent process with a holistic review, plan fiduciaries could reasonably conclude that an investment that includes revenue sharing fees is superior and more appropriate for the plan than an investment that does not engage in revenue sharing.**
- **All else being equal—some revenue sharing arrangements actually result in lower recordkeeping fees.**

Possible Approaches (cont'd)

- **In comparing funds and considering costs, focusing exclusively on revenue sharing may lead to misleading conclusions.**
- **Funds with higher revenue sharing are not necessarily the funds with the highest expense ratios.**
- **As the example shows, a fund with higher revenue sharing may have a lower overall expense ratio than other funds.**

Key takeaways for plan fiduciaries

- **Both the Department of Labor and the courts have confirmed that revenue sharing is not *per se* impermissible.**
- **Plan fiduciaries must be aware of how much revenue sharing is earned by service providers, and must ensure that total compensation for service providers is reasonable (not excessive).**
- **Plan fiduciaries have considerable discretion in determining how to allocate plan expenses.**
- **In evaluating investment cost, the relevant consideration is total cost (not just the amount of revenue sharing).**
- **In making investment decisions, investment cost is not determinative, but rather only *one* factor that must be considered as part of a prudent process.**

Thank You

Richard K. Matta, Principal
Groom Law Group
rmatta@groom.com

Andrew L. Oringer, Partner
Dechert
andrew.oringer@dechert.com