Rethinking Revenue Sharing

Daniel A. Notto
Senior Retirement Plan Counsel at AllianceBernstein

It would be an understatement to say that defined contribution (DC) plan fees have been getting a lot of attention in recent years. Recent US Department of Labor (DOL) regulations require detailed fee disclosures to plan sponsors and plan participants. There has also been a rash of lawsuits over fees that have cost several large plan sponsors millions of dollars in settlements and judgments.

These are some of the developments prompting lively and important conversations about DC plan fees. Plan sponsors, their advisors, service providers, the courts, journalists and plan participants are asking many questions about fees, including: How much are they? Are they reasonable? Who pays them? How do service providers receive them and from whom? Are there any conflicts of interest inherent in the fee arrangements? What should plan fiduciaries do?

But perhaps the most interesting question arising out of the fee debate is what role revenue sharing plays (or ought to play) in the financing of costs for DC plan services.

Longstanding Practice Now Under the Microscope

Revenue sharing is the longstanding practice of using payments associated with a plan’s investments to pay for plan recordkeeping or other services. For example, a mutual fund (or its transfer agent or distributor) might pay a recordkeeper a fee of 0.10% (10 basis points) of the fund’s assets that are invested in the plans of the recordkeeper’s clients. Sometimes these payments are held in a separate bookkeeping account by the recordkeeper or are held in an account within the plan. In either case, these payments are generally applied toward the recordkeeper’s fees for operating the plan or used to pay other plan service providers. These accounts are sometimes referred to as “ERISA accounts.”

The courts and the DOL recognize that revenue sharing is a legitimate way to pay for the costs of operating a plan. But a 2013 ruling from the DOL1 puts this fee structure in a new light by clarifying a plan sponsor’s fiduciary duties to evaluate and monitor revenue-sharing arrangements. And in that advisory opinion issued by the DOL, some finer points concerning DC plans’ ERISA accounts—also referred to as plan reimbursement accounts or ERISA budgets—were directly addressed.

“ERISA accounts” is a bit of a misnomer, since they are not mentioned in the Employee Retirement Income Security Act of 1974. Essentially, these plan reimbursement accounts are a bookkeeping convenience within a DC plan wherein revenue sharing gets pooled and then distributed later, either to offset plan expenses or allocated among plan participants in some equitable fashion. Revenue sharing is certainly legal, and a significant number of plans do use it, although the prevalence of revenue sharing is decreasing as more plans rethink their strategies for making plan fees more transparent.

---

1Advisory Opinion 2013-03A
Clarifying Some Revenue Sharing Questions

Do revenue-sharing payments constitute plan assets? That was the question posed to the DOL in the advisory opinion. The DOL stated that the answer depended on whether or not those revenue-sharing payments are made to the plan itself. If yes, then those monies are plan assets. If they're not put into the plan, but rather kept in a recordkeeper's general accounts (although earmarked for the benefit of that particular plan), then they’re not plan assets.

What’s embedded in this question is the principle that the person holding plan assets is a fiduciary. So, if a recordkeeper was keeping revenue-sharing monies in a separate account (not within the plan) and they were deemed to be plan assets, that would make the recordkeeper a fiduciary. This would consequently violate an ERISA rule requiring plan assets to be held in trust, and it would raise potential prohibited transaction concerns.

This part of the DOL's response was fairly straightforward (and expected), but the DOL went further, clarifying the fiduciary’s responsibility in relation to revenue sharing—adding what we believe will become the fiduciary standard for any plans that use revenue sharing.

Informed Decisions, Reasonableness of Fees

Essentially, this advisory opinion makes it clear that ERISA’s “prudent expert” standard for fiduciaries applies to revenue-sharing arrangements. Plan fiduciaries must clearly understand the agreement with their recordkeeper in order to make an informed decision on the reasonableness of the arrangement. If the recordkeeper is an advice fiduciary, conflicts of interest may arise. For example, the recordkeeper’s advice might steer somebody to investments that result in higher revenue-sharing receipts for the plan's recordkeeper. The plan's sponsor has a fiduciary duty to make sure the plan doesn’t engage in any such prohibited transactions, so the plan's sponsor has some responsibility to make sure that doesn’t happen.

Plan sponsors also need to understand the formula, methodology and assumptions the recordkeeper uses to pay service providers or to credit revenue sharing back to the plan. The DOL’s advisory opinion also stipulates that plan sponsors must periodically monitor the recordkeeper to assure that the revenue sharing is being correctly calculated and applied. Plan sponsors should make sure that the revenue sharing is being used in accordance with the agreement and that the fees paid by the recordkeeper to other service providers out of the ERISA account are reasonable.

For example, if the ERISA account is used to pay the plan auditor or a plan communication service provider, the plan sponsor has to get enough information to determine whether those fees are reasonable as well.

Coming to Grips with Excess

As plans mature and get larger, the problem of excess revenue sharing enters the picture. That’s when the revenue sharing coming from fund providers exceeds the amount necessary to pay for the plan’s expenses. And plan fiduciaries have to decide what to do with the excess revenue-sharing amounts—how the plan will use that money. If an investment policy statement or other plan documents state how excess revenue sharing is to be used, plan sponsors must follow these rules.

---

Evaluating Revenue Sharing: Fiduciary Responsibilities

- Understand the agreement with the recordkeeper regarding the use of revenue sharing
- Obtain sufficient information about all fees and other compensation to make an informed decision about whether the recordkeeper’s compensation is reasonable
- If the recordkeeper is an advice fiduciary, evaluate whether revenue sharing leads to conflicts of interest or self-dealing
- Understand the formula, methodology and assumptions the recordkeeper uses to pay service providers or credit revenue sharing to the plan
- Periodically monitor the recordkeeper to assure that revenue sharing is being correctly calculated and applied
- Obtain sufficient information to assure that fees paid by the recordkeeper to other service providers out of the ERISA account are reasonable
Another issue with excess revenue sharing is whether it is allocated among participants, and if so, how is it allocated. The DOL allows fiduciaries a fair amount of latitude in allocating plan expenses and has noted, on a few occasions, that ERISA doesn’t specify any particular way. Consequently, we believe the same latitude would apply to revenue sharing as well, which amounts to a type of rebate of fees.

Ultimately, the use of excess revenue sharing is a fiduciary decision. If that decision is a considered decision—made with sufficient information and without being arbitrary or capricious—then it will likely be deemed reasonable and acceptable under ERISA. There is, however, an evolving concern that you should keep the costs that participants pay directly down, and that something may be wrong (or appear wrong) if a plan has a lot of excess revenue sharing. Oftentimes, revenue sharing is not equivalent among all funds; some funds pay no revenue sharing and others pay different revenue-sharing rates. The issue then arises that it may not be fair that some participants pay a higher expense ratio because there’s revenue sharing built in. Another concern is that participants who invest in more expensive, revenue-sharing funds are bearing disproportionately more of the plan’s administrative costs than their coworkers who chose funds without revenue sharing.

DC plans and their fiduciaries may be better served to modify or change the plan design a bit, and it might be wise to consider removing excess revenue sharing from the picture altogether. One route to that solution would be to consider share classes or investment vehicles with lower—or no—revenue-sharing rates.

Rethinking Revenue Sharing

At the same time that regulatory scrutiny is increasing, a recent survey indicates that the percentage of large plans using revenue-sharing-based fee compensation or fee structures has declined over the last few years. Of those plans that continue to use revenue sharing, the revenue-sharing rates are going down.

How should plan administration costs be paid? Is revenue sharing an appropriate way to pay for costs? Resolution of these issues requires increased consideration from all parties involved: retirement services providers, recordkeepers, plan sponsors, advisors, consultants and the government.

There’s no dispute over the legality of revenue sharing; even recent court decisions have affirmed it. But with revenue-sharing arrangements containing potential inequities, plan fiduciaries and their advisors have expressed a growing interest in classes of mutual fund shares without any revenue sharing. These share classes go by various names, depending on the fund complex. For example, some call their non-revenue-sharing classes “Class Z” (including AllianceBernstein mutual funds); others use “R-6.” Typically, non-revenue-sharing classes have a net expense ratio that’s lower than other share classes of a particular fund. Another way to eliminate the issues surrounding revenue sharing is to use collective investment trusts (CITs) as the underlying investment vehicles instead of mutual funds. CITs typically don’t engage in revenue sharing and are usually less expensive than mutual funds because they have lower compliance, marketing and administrative costs.

Advisors and consultants can help DC plan sponsors move toward greater fee transparency by opening a dialog with them about incorporating non-revenue-sharing classes or CITs into their investment menus.

The bottom line for a plan fiduciary is to make an informed decision. Get enough information to think the issue through, work with the plan’s advisors or consultants, make a decision and document that decision. That is how plan sponsors—as fiduciaries—can do the right thing for their plan participants and protect themselves at the same time.

\footnote{Defined Contribution Plan Fees Continue to Decline: 2013 NEPC Plan & Fee Study, published by NEPC, September 2013.}
For plan sponsor, financial advisor or pension consultant use only. Not for inspection by, distribution or quotation to, the general public

The information contained here reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed here may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal or accounting advice. It does not take an investor’s personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer or solicitation for the purchase or sale of, any financial instrument, product or service sponsored by AllianceBernstein or its affiliates.

AllianceBernstein® and the AB logo are registered trademarks and service marks used by permission of the owner, AllianceBernstein L.P.

© 2014 AllianceBernstein L.P.