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An Update on 401(k) Plan Investment Issues, and Revenue Sharing In Particular

In the last year or so, there have been a lot of developments in the law relating to the investment of 401(k) plan assets. There have been several important cases, and the implementation of DOL regulations requiring the disclosure of detailed information on fees, both from third party providers to plan sponsors and from plan sponsors to participants. This seems like a good time to address the question of what issues should be of concern to a plan committee that is charged with reviewing the performance of investments and the compensation of third party providers. We assume, for purposes of addressing this question, that we are dealing with a 401(k) or 403(b) program that allows participants to self-direct the investment of their accounts by making 404(c) investment elections from among a set of investment options chosen by a plan committee and reviewed periodically by such committee.

Here is a status report on some issues that should be of concern to a plan committee:

1. ***Is the selection of investment options a fiduciary act that is not protected by section 404(c) of ERISA?***

   It appears clear that the selection and review of the investment options is a separate fiduciary act. There is one case, Hecker v. Deere, from 2009, that suggests that Section 404(c) of ERISA ("404(c)") might offer complete protection to a committee as long as a sufficient number of options were made available to participants. But a change in the 404(c) regulations, and a more recent Ninth Circuit case, Tibble v. Edison, make it pretty clear that a committee should assume it has fiduciary responsibility for the selection and review of investment options, and the committee should act accordingly. There remains a suggestion in the case law that offering more investment options provides greater protection to the committee. But this line of reasoning in the cases may be at odds with an apparent trend among plan sponsors toward reducing choices in the plan's investment lineup in order to provide a more coherent framework for participants.

2. ***Can revenue sharing be used to pay plan expenses without the risk that it will be seen as a breach of fiduciary duty or a prohibited transaction?***

   Yes. All of the recent cases have explicitly or implicitly concluded that there is nothing wrong per se with revenue sharing (having a mutual fund either (a) pay a third party provider for direct expenses that would otherwise be paid by the sponsor or the plan, or (b) reimburse the plan sponsor or the plan that has paid those expenses). And the Department of Labor, relying on three 1997 Advisory Opinions, 97-15A, 97-16A and 97-19A, is still in accord. The rationale for it not being a prohibited transaction, set forth in 97-19A and in Tibble v. Edison, is that the revenue sharing is a reimbursement from a third party (a mutual fund) to a fiduciary for direct expenses. In other words, if the sponsor would otherwise have to pay the expenses, but is reimbursed by the mutual funds, that is not a prohibited transaction. But the additional issues set forth below should be considered.

3. *Do you need special plan or trust language to allow revenue sharing?*

We think, based on recent court decisions, that having such language is a good idea. In Tibble v. Edison, the plan originally provided that "the costs of administration of the Plan will be paid by the Company". The plan was subsequently amended to provide that "the costs of administration of the Plan, net of any adjustments by service providers, will be paid by the Company." While the Court allowed the sponsor to interpret the pre-amendment language to permit revenue sharing, it was clear that the amended language was preferable. In addition, in a different case, Tussey v. ABB, the district court, while indicating there is nothing wrong with revenue sharing, relied on investment policy statement language (to the effect that revenue sharing would be used to lower plan costs) to find the sponsor liable because it used revenue sharing for another purpose: to maximize a third party's fees rather than to lower costs. Consequently, the investment policy statement language, in effect, was the hook on which the court hung the decision against the sponsor. We suggest that language acknowledging the issue of revenue sharing be added to the plan or trust, and also that the plan's investment policy statement explicitly acknowledge the use of revenue sharing to pay the reasonable fees of third party providers and direct plan expenses.

Here is sample language that we think works:

> "The reasonable expenses of administering the Plan, net of any revenue sharing that reimburses or pays directly the fees of a service provider or other such expenses of administering the Plan, will be paid by the Trust; provided, however, that the Company may, in its discretion, pay some or all of such expenses of administering the Plan."

4. *Should funds be chosen with an eye to the revenue sharing they produce?*

This is a sensitive issue that is not yet resolved. Many sponsors wish to avoid having to either pay administration fees themselves or have such fees be paid from plan accounts. Revenue sharing is one way to achieve this result. But third party administrators will generally be candid about the impact of fund choice on the amount produced by revenue sharing. The use of index funds, and the movement to the least expensive share class, generally will reduce revenue sharing proceeds. So the question arises whether an

analysis of this interplay, and a resulting choice of funds that are not necessarily the lowest cost, is permissible. In this regard, the court in Tibble v. Edison warned that its decision permitting revenue sharing assumes that "fiduciaries are not being driven to select funds because they offer them the financial benefit of revenue sharing", and that if that assumption is not true, the court would not rule out the possibility that liability might attach. We think this language should be taken seriously, and that the plan committees' records should be careful not to let the potential amounts of revenue sharing it receives cloud its decision-making regarding the best fund choices to offer participants in the fund lineup.

5. *What if revenue sharing exceeds the expenses it is intended to cover?*

Although this question has not been addressed in any of the aforementioned case law, or in any DOL or IRS guidance, the possibility of "excess revenue sharing" does appear to be a more common occurrence. We know of several instances where third party administrators (Fidelity and TIAA-CREF) have notified sponsors that there is excess revenue sharing resulting in "credits." Advisory Opinion 97-19A raised the possibility of an excess that would be paid into the plan, but the DOL, while acknowledging the suggestion, did not indicate whether it was permissible. One significant problem is that the rationale for revenue sharing assumes that the amounts paid by the mutual funds are not plan assets, but instead constitute other amounts paid to the mutual fund advisor from the mutual fund as expenses and then shared with other parties. If that is the case, then if there are funds left over after they are shared, how can they find their way into the plan? Are they contributions? If so, then shouldn't they be subject to the Internal Revenue Code's non-discrimination rules, and contribution limits such as Internal Revenue Code section 415? Or are they investment earnings, and if so, then was the reduction by the mutual fund a use of plan assets? We note that third party administrators, while permitting excess revenue sharing, generally do not take responsibility for allocating it, but leave such decision up to the sponsor as to how the excess should be utilized. Is that sponsor's action a settlor act or a fiduciary act? We think that until these issues are answered by DOL, the IRS and the courts, it is risky to have the excess revenue sharing funds find their way into the plan and allocated to participant accounts, and sponsors should be very cautious about taking this step.

Questions or Assistance?

If you have questions about this alert, please contact one of the members of our Employee Benefits Practice Group pictured on page 1 of this alert.

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