"Whack-A-Mole[i]": Catch Me If You Can

Fiduciary Considerations in Controlling and Accounting for Plan Administration Fees

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CHAO & COMPANY
FIDUCIARY MATTERS

Highlight

- Controlling plan expenses is an important fiduciary duty. An ERISA retirement plan fiduciary must have a good working knowledge of who pays and how the plan expenses are paid, to make sure that such expenses are deemed reasonable. Decisions should be fair and equitable to all plan participants and beneficiaries.

- The need to demonstrate prudence when selecting a service provider is obvious. Most plan fiduciaries take steps through a competitive bidding process to identity, analyze and engage their service providers. However, most plan sponsors tend to be much less vigilant in exercising prudence with regards to ongoing monitoring of the providers' services, fees and value.

- Officers and executives of an employer owe their duty of loyalty to the company, and when they serve as retirement plan fiduciaries, they owe their duty of loyalty to plan participants and beneficiaries. This same group of executives is at times placed in an untenable position of serving two masters and invariably leads to conflicted, nonparticipant-centric decisions; a clear violation under ERISA.

- There is no such thing as a "free" plan. Revenue share continues to play an important and complex role in plan expenses. Plan fiduciaries should carefully understand the revenue share generation and flow between asset managers, the recordkeeper, the custodian and the plan. This affects the fiduciary decisions of how plan expenses shall be paid and expressed, the appropriate investment share class to select, and how to discharge plan expenses if there is a revenue share deficit or what to do if there is excess revenue share after all reasonable plan fees and expenses have been paid.

- ERISA §§ 408(b)(2) and 404(a)(5) have brought improved transparency to plan fees and expenses. This is an important and necessary disclosure to both plan sponsors and participants respectively. However, increased disclosure is not a substitute for good judgment. In fact, as data becomes more available, the threshold for making an informed decision rises.

- Every fiduciary decision is based upon facts and circumstances then prevailing. The best course of action is to develop a prudent, consistent and documented decision making process. Plan fiduciaries are entrusted with "other people's money" and should be mindful of their duel duties of loyalty and due care. This is extended to understanding, analyzing, and controlling plan expenses in the context of the inter-relationship between service provider (bundled and unbundled), investment options (proprietary and non-proprietary), brokers and intermediaries, and the plan.

Introduction

The shift from defined benefit pension plans to defined contribution plans over the past thirty years requires plan fiduciaries to emphasize their duties differently. In the defined benefit world, the emphasis has been on proper funding for and sustainable payments of promised benefits to workers. Plan sponsors retain the funding, investment and plan administration risks entirely. The prudent management of plan costs benefits the plan sponsors and does not directly affect the retirement benefits of participants. The fiduciary emphasis is to prudently meet the agreed-to obligations. Under a defined contribution scheme, much of the risks are transferred to or shared with employees. Even though the duties of a plan fiduciary remain serving the best interests of the plan participants and beneficiaries, the fiduciary frame and focus necessarily have to pivot. In the defined contribution world, plan sponsors make no end date benefit promise. Instead, "tools" are laid out for participants to make individualized savings and investment decisions. Participants take on a majority of the funding and all of the investment and outcome risks and rely on the plan fiduciaries to deliver the most prudent "tools" in a cost efficient manner. These "tools" include investment options, account recordkeeping and reporting, education/guidance/advice, administrative services, a custodial trading platform, plan documents and all required disclosures and notices.

Under a defined contribution scheme, the control and responsibility for participant benefit outcome is substantially shifted from the plan sponsor to the participant[1]. However, the plan sponsor remains fully and solely responsible for maintaining the plan, meeting regulatory requirements, providing timely notices and disclosures, prudently selecting and monitoring investment options and service providers and controlling expenses. Thus, plan fiduciaries must be mindful of their actions and inactions that may detract participants' probabilities of realizing their individual retirement income objectives. Simply stated, plan fiduciaries should make every effort to minimize roadblocks for participants to have the greatest probability in meeting their retirement income replacement goals. Understanding the complex relationship between investment, fees and service provider is one primary step towards making this a reality.

This paper narrowly focuses on the fiduciary considerations regarding the treatment of plan expenses[ii] under an individual account-based, self-directed, defined contribution retirement plan such as a 401(k), 403(b) or a 401(a) account. The hide and seek nature of revenue generated by asset managers (e.g. mutual funds) under a proprietary or affiliated bundled service arrangement or under an open-architecture alphabet soup share class approach purposely or inadvertently confuses the fiduciary. It is truly a financial game of Whack-A-Mole.

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[1] i.e. establishing realistic retirement income accumulation goals, making real and achievable assumptions, periodic monitoring and assessing progress, determining contribution rate, understanding the dynamic risk-return tradeoff decision, portfolio construction, making underlying investment selection and rebalancing decisions, etc.

The Employee Retirement Income Security Act of 1974 (ERISA) contains no safe harbor provisions specifically addressing how plan expenses may be allocated among participants and beneficiaries. As such, the 2007 Report of the ERISA Advisory Council's Working Group on Fiduciary Responsibilities and Revenue Sharing Practices[iii] suggests that plan sponsors must understand all the plan fees and expenses to: 1) fulfill their responsibilities under ERISA; 2) evaluate the reasonableness of provider compensation; and 3) evaluate whether there are any prohibited transactions or other conflicts of interest. Plan sponsors and fiduciaries have considerable discretion in determining, as a matter of plan design or plan administration, how plan expenses are allocated among participants and beneficiaries[iv]. At the same time, fiduciaries should carefully select expense payment and reimbursement schemes that do not violate the non-discrimination provisions under Internal Revenue Code §401(a)(4)[v].

Fiduciary Standard

It is always worth repeating that ERISA fiduciaries[vi] are subject to a set of standards (Fiduciary Standard) under §404(a). When acting on behalf of retirement plan participants and beneficiaries, an ERISA fiduciary is expected to:

- Act in the ***sole interest*** of plan participants and their beneficiaries
- Act with the ***exclusive purpose*** of providing benefits to them;
- Carry out duties ***prudently***[vii];
- Follow the plan documents (unless inconsistent with ERISA);
- ***Diversify*** plan investments; and
- Pay only ***reasonable*** plan expenses.

The Fiduciary Standard can be generally grouped under two sets of broad duties: 1) the duty of loyalty and 2) the duty of due care. Further, the Department of Labor (DOL), under §408(b)(2)—Fee Disclosure final regulation, states that a plan fiduciary has the obligation to ensure that participants (hereon include active and inactive participants and beneficiaries maintaining an asset balance) under an individual account plan, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to the investment of assets held in, or contributed to, their accounts and are provided sufficient information regarding the plan, including plan fees and expenses, and regarding the Designated Investment Alternatives[viii] (DIAs) available under the plan, to make informed decisions with regard to the management of their individual accounts.

Settlor's Functions

ERISA § 403(c)(1) provides that employee benefit plan assets shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.

The use of plan assets to pay fees and expenses incurred would not be deemed appropriate if the payments are made for the employer's benefit[ix] or involve services for which an employer could reasonably be expected to bear the cost in the normal course of such employer's business or operations. In this regard, certain services provided in conjunction with the establishment, termination and design of plans, often referred to as "settlor" functions, relate to the business activities of an employer and, therefore, generally would not be the proper subject of payment by an employee benefit plan[x]. It is the responsibility of appropriate plan fiduciaries to determine whether a particular expense is a reasonable administrative expense under §§ 403(c)(1) and 404(a)(1)(A) of ERISA.

During circumstances where benefits are derived by both the plan sponsor and the plan and where one party appears to be acting in both a settlor capacity on behalf of the plan sponsor and in a fiduciary capacity on behalf of the plan's participants and beneficiaries, it would generally be necessary, in order to avoid violations of ERISA §§ 406(b)(1) and 406(b)(2), to have an independent fiduciary determine how to allocate the expenses attributable to those benefits[xi].

Decision Drivers

If all or a portion of the plan expenses are to be paid by plan assets, a number of questions should be answered to guide in the selection and implementation process.

1. What is considered "reasonable[xii]" plan administration expenses for the services provided, and how do fiduciaries sustain fee reasonableness over time?
2. Should plan administration fees be assessed on an asset-based, fixed fee or a combination basis?
3. Should revenue share be a source of funds to pay or offset plan expenses?
4. When selecting investment options, should all options have the same revenue share distribution rate?
5. How will the generation and deployment of revenue share payments be expressed and monitored in writing to the service provider?
6. How will the unallocated revenue share payments be treated?

Keep In Mind

Fiduciary prudence is about developing a fiduciary culture within the ERISA framework and formulating a process to make informed decisions based on the material facts and circumstances at the time a decision is made. Document each decision and the supporting facts for arriving at such a decision.

According to DOL Field Assistance Bulletin 2003-3[xiii]:

- When expense allocating is set forth in the plan documents, fiduciaries, consistent with §404(a)(1)(D), will be required to follow the prescribed method of allocation. The method of allocating expenses, in effect, becomes part of defining the benefit entitlements under the plan.

- 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.

Retirement Plan Fee Background

There are three main categories of plan fees and expenses and, when paid by plan assets, they impact the total return on investments[xiv].

1. **Plan Administration Fees.** The ongoing operation of a plan involves expenses for **Administrative Services** - such as plan recordkeeping, accounting, custodial, legal and trustee services, telephone voice response systems, access to a customer service representative, educational seminars, retirement planning software, participant level investment advice, electronic access to plan information, daily valuation, and online transactions.
2. **Investment Fees.** Expenses for investment management and other related services are paid as a percentage of assets invested (expense ratio for mutual funds). They are deducted directly from investment returns.
3. **Individual Service Fees.** Individual service fees may be charged separately[xv] to the accounts of those who choose to take advantage of a particular plan feature or to meet specific individual requests. For example, fees may be charged to initiate and complete a plan distribution or enroll in certain investment management account options or advice.

Keep In Mind

Fee and service benchmarking is an appropriate first step in making an informed and reasoned decision regarding fees and expenses for the services to be or being provided. Benchmarking is still in its infancy. With growing inputs from plans and service providers, the data set will become more robust, and benchmarking studies will be more reliable and comprehensive.

Service Arrangements

Some or all of the various plan services and DIAs may be offered by one service provider (e.g. an asset manager owns or is affiliated with a recordkeeper and a custodian) for a single fee paid to that service provider (referred to as a "Bundled Arrangement"). In other cases, plans may obtain services and DIAs from a variety of service providers (referred to as an "Unbundled Arrangement"). In this case, the fees and expenses for each service provider (e.g., investment manager, trustee, recordkeeper, third party administrator, custodian, investment advice provider, and communications firm) are charged separately. Plans may also use an arrangement which combines a single provider for certain services, such as administrative services, with a number of different asset managers or providers for investments.

Payment for Plan Administration Services

Plan Administration Fees can be assessed in the form of a fixed fee ("**Fixed Fee**"), a percentage of asset fee ("**Asset-Based Fee**"), or a combination thereof ("**Combo Fee**"). Depending on the service provider, how the fee is assessed and paid is negotiable. Under a Fixed Fee approach, it is typically expressed in a per participant basis with the negotiated fee remaining constant within an agreed to range of participant count (e.g. 501 to 750 is one per head fee and, if the participant count grows, 751 to 1000 is a lower per head fee) regardless of the plan asset size over time. Under an Asset-Based Fee approach, even though the negotiated percentage of the asset fee remains constant (e.g. a 35 basis point annual fee assessed on each plan valuation day), the amount of fees payable fluctuates based on the rise and fall of plan asset value. Under a Combo Fee arrangement, typically a smaller asset-based fee is added to a fixed flat fee. This allows the fee to grow as assets grow. It is not uncommon for a service provider to be more flexible during fee negotiation when asset-based fees are included with the pre-knowledge that the annual fee will likely grow and more than make up the price difference over time.

Plan fiduciaries have an obligation to make certain that the fee negotiated and agreed to is reasonable and transparent (ease in meeting the ongoing fiduciary duty of monitoring.) Unlike the Fixed Fee approach, the Asset-Based Fee approach can become unreasonable over time. For example, an initially agreed to asset-based fee of 20 basis point charges $200,000 per year for a plan with $100,000,000 in assets may be deemed to be reasonable for services negotiated at the onset. In five years, with the combination of asset appreciation and contributions, the plan assets could be valued at $150,000,000, a 50% increase without a comparable increase in services. This would lead to an automatic 50% increase in Plan Administration Fees. Recordkeeping costs do increase over time, but under an asset based fee approach when left unchecked, could be deemed excessive and unreasonable. The authority to grant fee increases should rest (and justified) completely with the plan fiduciaries and not automatically in the hands of the recordkeepers.

Bundled or unbundled service providers are seldom plan fiduciaries and do not have to meet the ERISA Fiduciary Standard. It is in their own best interest to offer an Asset-Based Fee or Combo Fee to automatically escalate their revenue over time. This automatic fee increase eliminates the need for these service providers to periodically request for a fee increase. The burden to make certain that fees are reasonable rests solely on the plan fiduciaries.

Keep In Mind

The duty to monitor is an important fiduciary responsibility. A prudent fiduciary process should not be a set-it-and-forget-it approach. Most fiduciaries and their advisors focus their efforts on selecting and monitoring plan investment options. Much has been written about the need to maintain a good working investment policy statement to prudently select but monitor plan investments. Developing a clear process to select and monitor service providers and their fees on a regular basis is equally important.

Determining "what" and "how" the Plan Administration Fees are paid are two separate decisions. As a part of its business decision, an employer (a non-fiduciary function) determines "what" amount of direct payment, if any, of the Plan Administration Fee would be paid for by the employer, and this may vary from year-to-year. If the employer elects not to pay any amount or if the amount elected is less than the negotiated annual Plan Administration Fee, the plan fiduciaries (a fiduciary function) would determine "how" the remaining Plan Administration Fees would be paid and expressed. After §408(b)(2) became effective, plan fiduciaries have been able to access an increasing amount of service provider data to benchmark plan costs, fees and expenses. On the one hand this places a significant downward pressure on fees during the initial years, on the other hand, service providers will gravitate towards a tight fee range and unintentionally create an oligopolistic reality where the tight range becomes the "reasonable" reality.

Most plans rely on the plan assets solely or partially to cover Plan Administration Fees which take on three general approaches:

1. **Revenue Share Approach** - Use DIAs (typically mutual funds) that pay shareholder service fees[2] [xvi]("**Revenue Share**") to offset or pay Plan Administration Fees. This is referred to as "indirect: payments to service providers which must be accounted for under §408(b)(2). The Revenue Share payments are part of Investment Fees which are deducted automatically from investment returns. Under this method, it is expected that participants with larger account balances will generate the highest Revenue Share and pay a higher portion of the overall Plan Administration Fee. However, this may not always be so in practice. Please note that, certain asset managers also pay, in addition to Revenue Share, an investment distribution fee[xvii].

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[2] Revenue sharing supports a wide variety of distribution and shareholder servicing activities, including administrative record keeping and sub-transfer agent services that were traditionally viewed as investment fund responsibilities.

For simplification and discussion purposes, investment distribution fees, if paid, are deemed to be a part of Revenue Share.

To better understand the complexity of using Revenue Share to pay or offset Plan Administration Fees, we use 5 fictitious participants under a retirement plan to illustrate the disparity.

Assumptions:

- Participants A, B, C & D each have $100,000, and Participant E has $50,000 invested in the plan.
- The plan offers 4 DIAs distributing Revenue Share at different asset-based rates.

Investment	Revenue Share	Participant A Asset	Participant B Asset	Participant C Asset	Participant D Asset	Participant E Asset
DIA A	0.00%	$40,000	$25,000	$100,000	$0	$0
DIA B	0.10%	$20,000	$25,000	$0	$0	$0
DIA C	0.15%	$20,000	$25,000	$0	$0	$25,000
DIA D	0.25%	$20,000	$25,000	$0	$100,000	$25,000
Total Revenue Share		**$100**	**$125**	**$0**	**$250**	**$100**

This example illustrates that, although Participants A, B, C & D have the same amount of plan assets, each supports a different amount of the plan costs using Revenue Share generated from their accounts due to their different DIA allocation weightings. Participant C's DIA does not pay Revenue Share, thus Participant C pays nothing for Plan services under a pro rata approach. On the other hand, the Revenue Share generated by Participant E's DIAs is the same as Participant A even though Participant E has half the amount of assets in the Plan.

Further, if the plan assets organically grow over time, the amount of Revenue Share will escalate proportionally. There is a question of reasonableness regarding an ever escalating amount of Revenue Share being generated to pay for the same Plan Administrative Services (i.e. although the negotiated asset-based fee percentage remains unchanged, the absolute dollar paid increases over time). In fact, certain recordkeepers keep every Revenue Share dollar generated and, by contract, charge an additional per participant fixed fee as their total compensation. This can be deemed as unreasonable or excessive compensation over time.

2. **Modified Revenue Share Approach** - Some employers do not predetermine and set the exact dollar amounts of their contributions towards offsetting the total Plan Administration Fee. Instead, they agree to be fully responsible for any "remaining" Plan Administration Fees that have not otherwise been paid for or offset by Revenue Share payments generated through plan investments.

3. Participant-Based Approach – This method divides the Plan Administration Fees by the number of participants under the plan to derive the annual per participant account fee and is typically deducted from each participant's account on a quarterly basis. This approach is often used when DIAs do not offer any Revenue Share payments or when the Revenue Share payment is insufficient to cover the agreed to Plan Administration Fee.

When complying with the ERISA Fiduciary Standard of sole interest, exclusive purpose and paying only reasonable plan expenses, a plan fiduciary has the obligation to prudently select service providers and negotiate a reasonable fee for carrying out the Administrative Services. If Revenue Share paying DIAs are selected, a plan fiduciary should have a clear written understanding with the service provider regarding the ownership and treatment of Revenue Share and any Revenue Share remaining ("**Revenue Share Credits**") after the Plan Administration Fee has been satisfied. Further, the plan fiduciary should be provided with information to oversee and monitor the service provider's collection and allocation of Revenue Share and distribution of the Revenue Share Credits.

Under either the Revenue Share Approach or the Participant-Based Approach, a fiduciary is likely meeting the required sole interest duty without conflict of interests since all Plan Administration fees are borne by the plan. This does not necessarily mean the duty to control expenses is met. However, under the Modified Revenue Share Approach, a conflict of interest (i.e. perceived as not meeting the sole interest standard) may arise. Plan fiduciaries have the sole responsibility to select DIAs and their Revenue Share distribution rate (mutual fund share classes are specifically created to distribute varying amounts of Revenue Share). The same fiduciaries must also carry out the employer commitment to pay all "remaining" portion of the Plan Administration Fees, a conflict appears unavoidable. The discretion to move along a Revenue Share continuum allows the plan fiduciary to inadvertently (if not purposely) favor the employer vis-a-vis the plan which would be contrary to ERISA's sole interest requirement.

Keep in Mind

A plan fiduciary, by appointment or by action, is the steward of participants' assets and has the obligation to serve in their sole interest. A fiduciary must remove himself from a position of conflict. If there is ever any doubt, seek advice from legal and other professional counsel.

ERISA Account vs. Pension Expense Reimbursement Account

When Revenue Share payments are used to offset Plan Administration Fees, all Revenue Share payments are deposited in an "account", and in turn, the account assets could be allocated to offset Plan Administration Fees periodically. This approach captures and accounts for all such indirect payments thereby removing the incentive for service providers to steer participants to higher Revenue Share investment options for self-gain. As stated earlier, beware of service providers that keep all Revenue Share as a part of their compensation, regardless of the amount received, there is no cap to their compensation.

There are typically two approaches to account ownership:

1. ERISA Account (ERISA budget, Revenue Sharing Account or ERISA expense account)
   All Revenue Share payments derived from DIAs are paid to an ERISA Account that is owned by the Plan and considered as plan assets. This is an unallocated suspense account awaiting plan fiduciary directives. Any unallocated account assets are often referred to as Revenue Sharing Credits.

2. Pension Expense Reimbursement Account
   All Revenue Shares derived from DIAs are retained by the service provider, such as the recordkeeper, as its general assets and maintained in a notional (bookkeeping records) account for all Revenue Share received and used to offset Plan Administration Fees.

Under the ERISA Account approach, fiduciaries must treat the account assets with the same care and prudence as any other plan assets. According to DOL Advisory Opinion 2013-03A[xviii], plan assets generally include any property, tangible or intangible, in which the plan has a beneficial ownership interest. A plan generally will have a beneficial interest in particular assets if the assets are held in a trust on behalf of the plan or in a separate account with a bank or other third party in the name of the plan or if it is specifically indicated in documents governing the arrangement that separately maintained funds belonging to the plan.

On the other hand, the mere segregation of a service provider's funds to facilitate administration of its contract or arrangement with a plan, such as the Pension Expense Reimbursement Account, or by any other name, would not in itself create a beneficial interest in those assets on behalf of the plan. The drawback with this approach for deploying Revenue Sharing Credits is that any assets remaining in such an account would be forfeited if the service provider's relationship with the plan is terminated.

Distribution of Revenue Sharing Credits

Currently, there is no guidance from the DOL or the IRS regarding the timing for distributing unallocated Revenue Sharing Credits from an ERISA Account within a retirement plan. However, a plan fiduciary may wish to refer to IRS guidance regarding plan forfeitures held in a suspense account as a prudent approach when considering Revenue Share Credit distribution. According to the IRS[xix], plan forfeitures must be used or allocated in the plan year incurred. The IRS does not authorize forfeiture suspense accounts to hold unallocated monies beyond the plan year in which they arise. 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 would preclude 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.

Prudent investment selection to include the specific share class for each DIA under a retirement plan is an important fiduciary function, and controlling Investment Fees and how Plan Administration Fees are paid are integral components of the selection decision. In a perfect world, for those plans electing to use level Revenue Share (i.e. every DIA pays the same Revenue Share) distribution to pay or offset Plan Administration Fees and other eligible non-settlor related expenses, the exact amount of Revenue Share is generated and paid on a timely basis. In the real world, the process is less straightforward and exacting. Depending on the DIAs each participant selects and the amount of contributions allocated to each DIA that often generates Revenue Share at a different rate, participants would most likely shoulder disproportionate amounts of Plan Administration Fees. To further compound this reality is the likely inexactness in returning the unallocated portion of the Revenue Share Credits. This all leads to a question of fairness and equity.

There are three general methods for returning unallocated Revenue Share Credits to participants:

1. Pro Rata Approach

Each participant receives a pro rata share of the unallocated Revenue Share Credit in the suspense account. Thus the participants with the highest asset balance will receive proportionally the greatest Revenue Sharing Credits (i.e. each participant asset balance divided by the total plan asset and multiplied by the unallocated Revenue Share Credit amount). Although this is often the most administratively convenient, it may not be the most equitable distribution approach. Using a disparate group of DIAs distributing anywhere from zero to a high Revenue Share asset-based payments, the larger asset balance could be responsible for generating a lower Revenue Share than a participant with a smaller asset balance.

One method to eliminate this potential disparity is for plan fiduciaries to select DIAs that pay a uniform Revenue Share (e.g. each DIA generates a Revenue Share of 15bp). This means that the share class selected for each DIA, to include stable value or money market fund, distributes the same Revenue Share percentage. Under this scenario, the pro rata approach is an equitable way in allocating the Revenue Share Credit since the Revenue Share generated from each dollar in plan asset is level. Therefore, when allocating Revenue Share Credit under the pro rata approach, a participant's asset size would be the only determination factor. From a practical standpoint, this approach can often be challenging since all asset managers do not offer DIAs based on a standardized set of Revenue Share paying share classes. Moreover, money market funds and passively managed index funds outside a variable annuity contract rarely offer any Revenue Share payments.

Here is a simple example to illustrate what seems intuitively fair and equitable under the pro rata Approach in returning Revenue Share Credits based on assets as a % of a plan may now be deemed unfair or inequitable
Assumptions:

- The same Participants A, B, C & D each have $100,000, and Participant E has $50,000 invested in the plan as in the previous example.
- The plan offers 4 DIAs distributing Revenue Share at different asset-based rates.

	Account Asset	Asset as a % of Plan	Revenue Share	Revenue Share %
Participant A	$100,000.00	22.22%	$100	17.39%
Participant B	$100,000.00	22.22%	$125	21.74%
Participant C	$100,000.00	22.22%	$0	0.00%
Participant D	$100,000.00	22.22%	$250	43.48%
Participant E	$50,000.00	11.11%	$100	17.39%
Total	**$450,000.00**	**100.00%**	**$575**	**100.00%**

Under the Pro Rata Approach in allocating Revenue Sharing Credits, Participants A through D would have received equal amounts in Revenue Share Credits since they each have the same 22.22% share of the total plan assets. It is clear that, from a Revenue Share generation percentage standpoint, Participants A through D are not identical at all.

2. Per Capita Approach

Although this is rare, Revenue Share Credits can be returned or allocated on a per capita basis. This means that each participant, regardless of the size of their retirement assets under the plan or the amount, if any, of the total Revenue Share originally generated from their individual accounts, will receive the same dollar amount of Revenue Share Credit.

3. Revenue Restoration Approach

Participants receive their proportional amount of Revenue Share Credits based on the Revenue Share generated under the plan during the crediting period on a dollar-for-dollar basis. This approach allocates to those participants whose accounts are responsible for generating the Revenue Share Credits. Since not every account is invested in investments that distribute Revenue Share payments, in order to level plan fees among all participants, a per capita fixed fee component would be used in conjunction. For example, if the Plan Administration Fee is $100 per capita per year, a) participant accounts that do not generate any Revenue Share payments would be assessed the full $100 for the year, b) accounts that generate Revenue Share payments in excess of $100 would have Revenue Share Credit returned to their accounts on a dollar-for-dollar basis and c) accounts that generate less than $100 in Revenue Share would make up the shortfall with a fixed fee.

The Revenue Restoration Approach is gaining popularity as recordkeeping systems gain more computing power and sophistication (few recordkeepers are currently able to provide this solution.) However, this approach is not limited only by technology or willingness; rather, certain asset managers with affiliated recordkeepers under a bundled service approach may deem certain provisions under the 1940 Investment Company Act to prohib such an approach when registered products are used as DIAs. This topic is beyond the scope of this paper.

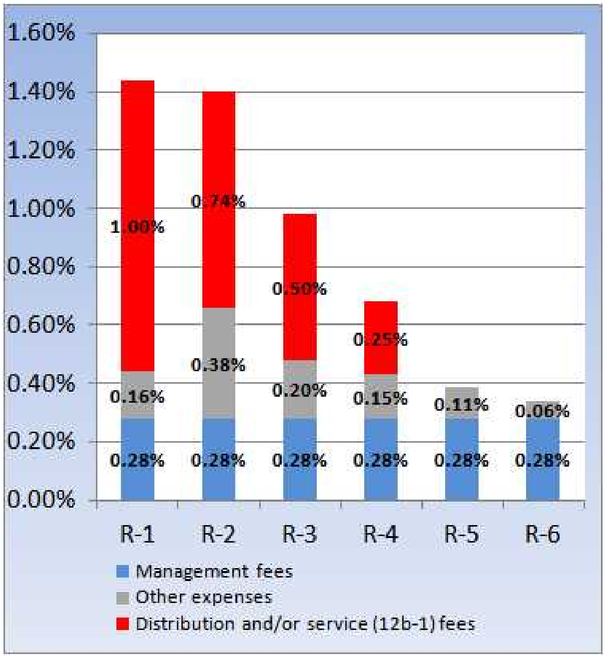
Regardless of the approach selected in returning or allocating Revenue Share Credits, plan fiduciaries should be mindful of the amount of Revenue Share Credits generated on an ongoing basis. Although using Revenue Share to pay or offset reasonable Plan Administration Fees is permissible by the DOL, generating an excessive amount of Revenue Share beyond the annual required plan fees and expenses may be deemed to be imprudent. After all, Revenue Share Credits (a plan asset) are not invested in accordance with each participant's investment direction (or defaulted selection) and could contribute to additional fiduciary risks, not to mention that excess amount of credits should not be considered as the best use of plan assets.

Keep in Mind

Revenue Share payments are derived and deducted directly from investment returns. As such, prudently selecting investment options must include a clear and purposeful analysis and decision regarding Revenue Share. Striking the proper balance between quality plan services, controlling plan expenses, and calibrating the amount of Revenue Share Credits are ongoing fiduciary duties. Bear in mind that, even if Revenue Share Credits are returned under the Revenue Restoration Approach to participant accounts, while they remain in the ERISA Account, there is an opportunity cost lost. As such, minimizing Revenue Share Credits and allocating to participant accounts frequently maximizes fiduciary prudence.

For illustrative purposes only, the American Fund Growth Fund of America is used to demonstrate the fund expenses and the variety of 12b-1 Revenue Share distribution rates currently offered. All information regarding this fund has been taken from the current fund summary prospectus, dated November 1, 2013[3]. There are 16 different share classes offered, and for simplification purposes, only the "R" share class (representing share classes specifically designed for retirement plans) will be illustrated. None of the R Shares carry a front or back end sales charge. The following table summarizes the fees and expenses that make up the total annual fund operating expense for each R Share class fund - i.e. the expenses that are paid each year as a percentage of the value of investment in the fund.

[3] The American Fund family is one of the first asset managers that created "R" share class funds specifically designated for retirement plan sponsors. Growth Fund of America is used to highlight the differences in expenses and is not a criticism, endorsement or promotion of this fund or the American Fund family. The selection of this fund should not be perceived as the best of worst example pertaining to the subject matter. We express no opinion regarding the prudence or suitability regarding this investment in any share class. https://www.americanfunds.com/pdf/mfgeipx-005_gfap.pdf



Share classes	1 year	3 years	5 years	10 years	12b-1
R-1	$147	$456	$787	$1,724	69.44%
R-2	$143	$443	$766	$1,680	52.86%
R-3	$100	$312	$542	$1,201	51.02%
R-4	$69	$218	$379	$847	36.76%
R-5	$40	$125	$219	$493	0.00%
R-6	$35	$109	$191	$431	0.00%

The example assumes that $10,000 is invested in the fund for the time periods indicated and then redeemed all of the shares at the end of those periods. The example also assumes that the investment has a 5% return each year and that the fund's operating expenses remain the same. Although the actual costs may be higher or lower. Based on the weightings of 12b-1 fees, we show the percentage of the overall cost that is attributable to such years during all reporting periods.

From a controlling plan expenses standpoint, R-6 share class is the obvious selection where the same investment is offered at the lowest annual fund operating expense. This is also the obvious answer if the plan fiduciaries elect to apply the Participant Based Approach to pay Plan Administration Fees. However, if the plan fiduciaries elect the Revenue Share Approach or the Modified Revenue Share Approach, a clear understanding of the required annual Revenue Share distribution to pay reasonable Plan Administration Fees and other plan level expenses is needed. Selecting the 'right" share class that best calibrates the Revenue Share distribution expected in order to minimize Revenue Share Credits is a fiduciary function. Furthermore, as the plan asset grows over time, the duty to monitor would require plan fiduciaries to affirm or change the share class selected.

Conclusion

1. Fiduciary Duties

In making decisions regarding an ERISA retirement plan, the employer should understand that there are two types of functions, settlor and fiduciary, and the costs related to settlor functions should not be borne by the plan and settlor decisions should not be made by fiduciaries. Fiduciaries subject to ERISA are required to act in the sole interests of participants and beneficiaries when discharging their duties for the exclusive purpose of the plan. Based on the facts and circumstances at the time, fiduciary actions must be prudent and free of conflicts or self-dealing. When making a fiduciary decision, always view each issue or question within the framework of loyalty and due care.

2. Understanding Fees & Expenses

In being a fiduciary and a steward for "other people's money", understanding fees and expenses is an important factor when selecting investment asset managers (e.g. mutual funds) and administrative service providers (e.g. recordkeepers). This pertains not only to the amount each investment (e.g. expense ratio) and administrative service provider (e.g. recordkeeper) charges, but also to the source of compensation for each service provider. This is especially challenging under a bundled services arrangement. Frequently, an asset-based fee is paid by the plan investments (asset managers) to the administrative service providers to subsidize them for plan services that would have otherwise been performed by the asset managers. Although the implementation of ERISA §§ 408(b)(2) and 404(a)(5) regulations have made fee and expenses more transparent to plan sponsors and participants, it does not go far enough, especially for bundled service providers, to clearly disclose and trace the flow of revenue share payments and credits among all parties.

3. Controlling Expenses

Fiduciaries are expected to control and pay reasonable plan expenses. Plan documents should clearly reflect how plan fees are paid and are consistent with service provider agreements. From a legal standpoint, the definition of what is deemed "reasonable" is best left to ERISA counsels. From a best practices standpoint, a prudent process must be developed for fiduciaries to derive an informed and reasoned decision. In the post §§408(b)(2) and 404(a)(5) world, an increasing amount of plan expense data is made available each year. Plan fiduciaries should use the combination of a well thought-out request for information (RFI) or request for proposal (RFP) process and a fee benchmarking study to gain a perspective regarding plan expenses. Issuing an RFP or RFI every three to five years and conducting a fee benchmarking study every two years would offer ongoing intelligence about plan fees and services as well as hold service providers' "feet to the fire."

Fee benchmarking remains in its infancy, and plan fiduciaries should have a clear understanding of its limitations. Benchmarking studies typically use a peer universe as a benchmark to rank the plan fees charged based on a set of services. Currently, the benchmark universe is relatively small and may not be the "best fit". Further, a check-the-box approach to listing a set of plan services being provided deprives a qualitative comparison or a more nuanced look at plan service and service standards. Value cannot be easily quantified by a benchmark study.

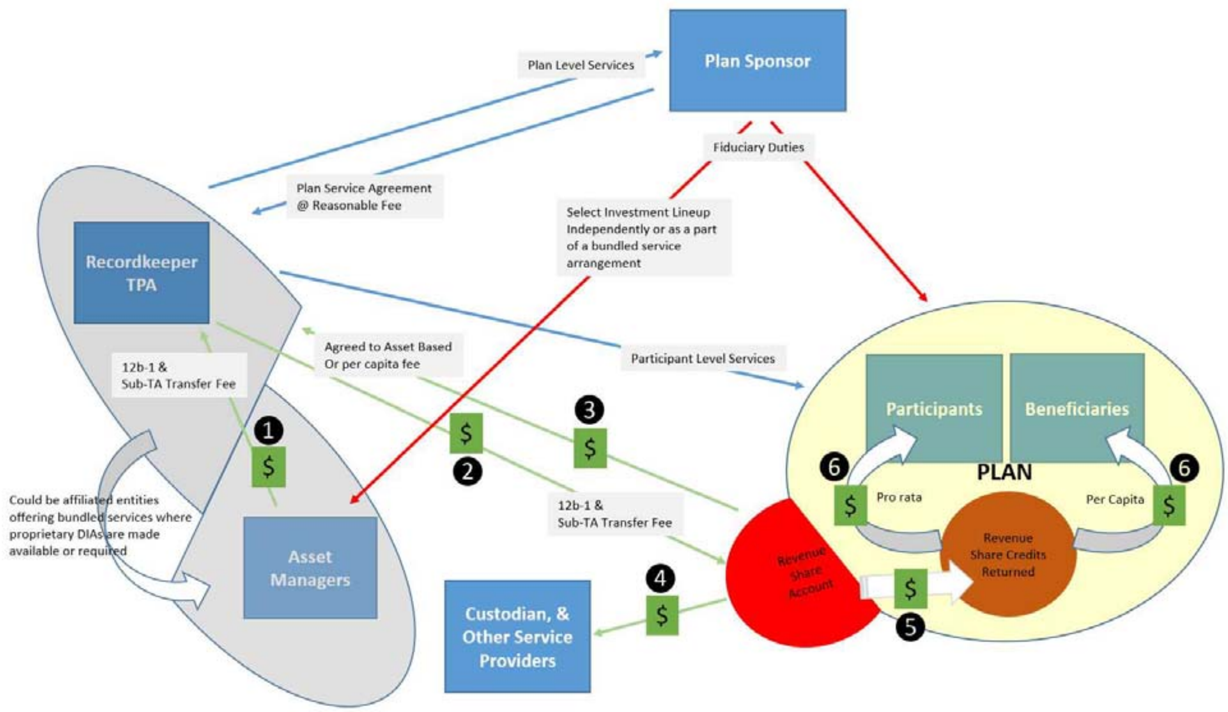
4. Fair & Equitable

There is no DOL safe harbor method for allocating Revenue Share Credits in ERISA accounts to participants. Needless to say, this fiduciary action should be fair and equitable to all participants and beneficiaries under the plan. Many plan sponsors default their decision to a pro rata distribution approach. Intuitively, these plan sponsors believe it is prudent to return the Revenue Share Credits according to the asset size of each account. This is typically based on the recommendation of service providers or the overarching assumption that the higher the account balance, the more Revenue Share generated. With improving technology and recordkeeping programming, systems are available to track each Revenue Share dollar generated per account. As such, each unallocated Revenue Share Credit can also be tracked and returned on a dollar-for-dollar basis to the same account where the credit was generated. This Revenue Restoration Approach would prevent the overpayment of Plan Administration Fees by those accounts that generate the most Revenue Share Credits regardless of account size or in any way subsidize those participants who have generated smaller or no Revenue Share.

Flowchart 1 on page 18 summarizes the basic services and payment flows discussed in this paper between the parties to a retirement plan. It assumes that all fees and expenses are paid by plan assets and there are unallocated Revenue Share Credits to be returned to participants.

Much about fiduciary prudence is based on the development and implementation of a well thought-out process for the sole interest of the plan participants. In many instances, it is the facts and circumstances at the time which determine and support the best course of action. DOL FAB 2003-3 points out that the expense allocation process must be rational. According to the Merriam-Webster Dictionary, rational means "based on facts or reason and not on emotions or feelings". The complexity in payment of plan fees and expenses requires plan fiduciaries to understand the financial relationship among asset managers and service providers. The first "rational" steps to winning the Whack-A-Mole game of catch-me-if-you-can is to "follow the money" and to deploy Socratic questioning.

Flowchart 1: Fee & Service Summary Flow Chart



❶: Fiduciary selected DIAs (and their share classes) may generate Revenue Share under 12b-1 and sub-TA Transfer fee payable to the recordkeeper as a way to compensate for services that have been transferred to the recordkeeper.

❷: Under contract, recordkeeper may either keep the Revenue Share or deposit all Revenue Share into a Revenue Share Account, which is then deemed plan assets.

❸: A portion of the Revenue Share is often used to pay recordkeeper for plan services.

❹: Another portion of the Revenue Share may be used to pay the custodian, legal and investment advisers, accounting and audit fees, or any other plan level fees.

❺: The unallocated net Revenue Share remaining in the Revenue Share Account is now referred to as Revenue Share Credits.

❻: It is a fiduciary decision as to the disposition of the Revenue Share Credits. Typically, the entire amount is returned to participants and beneficiaries. This should be completed by the end of the calendar year.

About Chao & Company, Ltd.

Chao & Company is a Securities & Exchange Commission Registered Investment Advisor and serves as an ERISA Section 3(21) investment co-fiduciary or ERISA Section 3(38) investment management fiduciary to qualified retirement plans such as 401(k), 403(b), and 401(a) plans.

Philip Chao, founder, principal and chief investment officer, is a strong advocate for upholding the fiduciary standard and insists on a fiduciary culture throughout his practice.

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The paper is for informational purposes only and should not be construed as an offer or solicitation to buy or sell a particular security, advice or service. Please consult with legal, financial, ERISA and investment professionals before taking any action regarding the subject matter. There should not be an expectation that this document, and any information contained or opinion expressed, will in all circumstances be updated, supplemented or revised, whether as a result of new information, changing circumstances, future events or otherwise.

Endnotes

[i] This trademark is registered to Bob's Space Racers, Inc. 427 15th Street Daytona Beach Florida 32117.
[ii] DOL Publication: A Look At 401(k) Plan Fees
http://www.dol.gov/ebsa/pdf/401kFeesEmployee.pdf

[iii] The 2007 ERISA Advisory Council's Working Group on Fiduciary Responsibilities and Revenue Sharing Practices
http://www.dol.gov/ebsa/publications/AC-1107b.html

[iv] Field Assistance Bulletin 2003-3
http://www.dol.gov/ebsa/regs/fab_2003-3.html

[v] A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section— if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of section 414 (q)).
http://www.gpo.gov/fdsys/pkg/USCODE-2010-title26/pdf/USCODE-2010-title26-subtitleA-chap1-subchapD-partI-subpartA-sec401.pdf

[vi] Fiduciary as so defined under ERISA Section 3**(21)**
(A) a person is a fiduciary with respect to a plan to the extent
(i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,
(ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or
(iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section1105 (c)(1)(B) of this title.

[vii] ERISA §404(a)(1)(B) - Prudent man standard of care
"with the care, skill, prudence, 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"

[viii] § 2550.408b–2 Final Regulation: A ''designated investment alternative'' is any investment alternative designated by the covered plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term ''designated investment alternative'' shall not include brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the covered plan.

[ix] ERISA §406(a)(1)(C)
A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest.

[x] March 2, 1987 DOL letter from letter Elliot I. Daniel to Kirk F. Maldonado.

[xi] DOL Advisory Opinion 97-03a
http://www.dol.gov/ebsa/programs/ori/advisory97/97-03a.htm

[xii] ERISA §408(b)(2)
Contracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor.

[xiii] http://www.dol.gov/ebsa/regs/fab_2003-3.html

[xiv] DOL Publication: Understanding Retirement Plan Fees And Expenses
http://www.dol.gov/ebsa/pdf/undrstndgrtrmnt.pdf

[xv] Field Assistance Bulletin 2003-3
http://www.dol.gov/ebsa/regs/fab_2003-3.html
ERISA and implementing regulations address certain instances in which a plan may impose charges on particular participants and beneficiaries. For example, section 104(b)(4) provides that the plan administrator may impose a reasonable charge to cover the cost of furnishing copies of plan documents and instruments upon request of a participant or beneficiary. Further, the Department's regulations under sections 404(c) and 408(b)(1) provide that reasonable expenses associated with a participant's exercise of an option under the plan to direct investments or to take a participant loan may be separately charged to the account of the individual participant. By contrast, regulations may limit the ability of a plan to charge a particular participant or beneficiary by requiring that information be furnished free of charge upon request of a participant or beneficiary.

[xvi] Revenue Share is a catch all term that includes SEC Section 12b-1 Fees, Shareholder Servicing fees, and Sub-Transfer Agency Fees. http://www.sec.gov/answers/mffees.htm#distribution
12b-1 fees - are fees paid by the mutual fund out of fund assets to cover distribution expenses and sometimes shareholder service expenses. SEC rule 12b-1 permits a fund to pay distribution fees out of fund assets only if the fund has adopted a plan (12b-1 plan) authorizing their payment. "Distribution fees" include fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares, and paying for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. The SEC does not limit the size of 12b-1 fees that funds may pay, but under FINRA rules, 12b-1 fees that are used to pay marketing and distribution expenses (as opposed to shareholder service expenses) cannot exceed 0.75% of a fund's average net assets per year.

Shareholder Service Fees - Some 12b-1 plans also authorize and include "shareholder service fees," which are fees paid to persons to respond to investor inquiries and provide investors with information about their investments. A fund may pay shareholder service fees without adopting a 12b-1 plan. If shareholder service fees are part of a fund's 12b-1 plan, these fees will be included in this category of the fee table. If shareholder service fees are paid outside a 12b-1 plan, then they will be included in the "Other expenses" category, FINRA imposes an annual 0.25% cap on shareholder service fees (regardless of whether these fees are authorized as part of a 12b-1 plan).

Sub-Transfer Agency Fees (Sub-TA Fees) - These are payments made to a Third Party Administrator or recordkeeper who holds an omnibus account for all participant investments within each fund. The responsibility maintenance and cost associated with individual participant accounts are shifted to these third parties, and the fund makes payment to compensate for such services. The fee ranges from 0.10% to 0.35%.

To learn more about mutual fund revenue share, please refer to "The Many Faces of Mutual Fund Revenue Sharing" December 13, 2013, by professor John A. Haslem, University of Maryland - Robert H. Smith School of Business
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2136614

[xvii] Certain mutual fund sponsors pay a distribution fee to recordkeeper or custodian who engage in activities that are designed to help facilitate the distribution of their mutual funds. Such additional payments are made in addition to annual service fees (12b-1 fees) and other fees and expenses disclosed in a fund's prospectus. These distribution payments are paid out from the asset manager or other fund affiliate's assets and not from the fund assets. Thus such payments would not be disclosed in the fund's prospectus.

[xviii] http://www.dol.gov/ebsa/pdf/AO2013-03A.pdf

[xix] Volume 7, Spring 2010, IRS Retirement Plan New for Employers
www.irs.gov/pub/irs-tege/rne_spr10.pdf