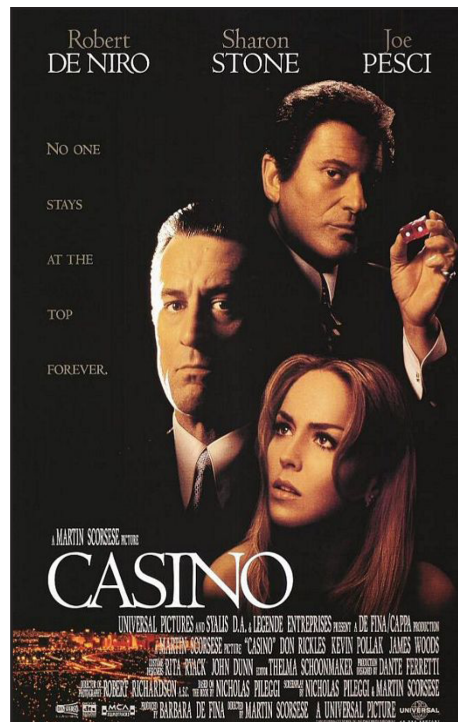
A Plan Sponsor's Guide to 401(k) Revenue Sharing

By Ary Rosenbaum, Esq.

One of my favorite movies of all time is Casino, directed by Martin Scorcese. It doesn't get as much love because it is often compared to GoodFellas, which was another mob movie that was directed by Scorsese, and also starring Robert DeNiro and Joe Pesci. Despite the criticism, it's a heck of a movie. One of my favorite scenes is when the man who helped the mob bosses skim the money from the casino count room, John Nash, was talking about how casino employees skimmed money from the money they were skimming. The employees were robbing the folks who were robbing the casino in which Nash said was "leakage". Leakage was an acceptable part of the casino skimming business because no matter how well you treated the employees, the employees are still going to steal a little extra for themselves. While the administration of 401(k) plans and the selection of investments are certainly more legal than casino skimming, the use of revenue sharing is "401(k) leakage". The problem with revenue sharing is that many plan sponsors are unaware of the true cost of the "free money" that mutual fund companies pay third party administrators (TPAs) to offset plan expenses. This cost is about the true cost of all of that "free revenue sharing money" and why plan sponsors may consider avoiding all revenue sharing pay funds.

What is revenue sharing?

In the 401(k) industry, revenue sharing is a compensation practice in which money is paid by mutual funds companies directly to TPAs to offset plan expenses because the plan sponsors used specific funds that these mutual fund companies managed. Revenue sharing may also include 12(b)(1) fees and sub t/a fees. Many fund companies pay revenue sharing fees in a variety of amounts and many mutual fund companies don't pay them. Many TPA firms and plan advisors champion the use of revenue sharing producing funds because these payments are supposed to be used to offset administrative expenses, which are usually borne by the plan participants. It should be noted that not every mutual fund can pay revenue sharing (because they can't afford it) and there are many share classes of some mutual funds that may or may not pay revenue sharing (as well as different



amounts).

The good old days of revenue sharing are long gone

In the good old days of revenue sharing, plan sponsors were recommended to add revenue sharing funds to their lineup and the fees went to the TPA with plan sponsors not knowing anything else. The plan sponsors didn't know how much revenue sharing payments were and how much in compensation that their TPA was making in total administrative costs. There were even cases where TPAs just pocketed the revenue sharing payments and never used it to offset costs. Thanks to litigation over plan expenses and the fee disclosure regulations, plan sponsors are no longer in the dark. TPAs must disclose any direct compensation charged to the plan and any indirect compensation they receive elsewhere, which would include revenue sharing. So plan sponsors now have the tools to discover whether the fees paid are reasonable or not which they can do when they determine the direct and indirect compensation that providers such as their TPA receives.

It's not free money; Plan participants are paying for it

For Ronald Reagan running for the third time as President in 1980, his watershed moment was when he grabbed a microphone during a debate that his campaign sponsored a debate that the moderator wanted to turn off. Reagan proclaimed: "I'm paying for this microphone!" Well revenue sharing payments don't come out of the sky; they come directly from the management expenses of the mutual fund companies charge to run a mutual fund. The management expenses of the mutual funds are going to be paid by the participants who invest in these funds and plan expenses do cut into the financial gain a plan participant can make on those mutual fund assets. The fact is that mutual fund companies that charge higher management expenses are the mutual funds more likely to pay revenue sharing because they charge enough in expenses to pad and tuck that revenue sharing reimbursement into their fees. A low cost index fund like the Vanguard Index 500 can't afford to pay revenue sharing payments of 15-25 basis points to TPAs when their management expenses are only 17 basis points (.17%). Plan sponsors need to understand that

there is a cost to revenue sharing, meaning that revenue sharing payments are something they plan participants are currently paying. It may not be robbing Peter to pay Paul, but it's making Peter to overpay, so you can offset Paul's fee.

Is revenue sharing illegal? No

Revenue sharing has been a longstanding practice in the 401(k) industry and will likely be that way for sometimes. The Department of Labor in three advisory opinions in 1997 allowed plan sponsors to use revenue sharing fee to offset plan expenses. Even in cases where plan sponsors where held to have breached their fiduciary duty for using mutual funds that were too expensive such as in Tibble v. Edison, the courts have recognized the right to collect revenue sharing payments to offset plan expenses. The reason that the defendant in Tibble, a California based utility lost the case for violating their duty of prudence is because revenue sharing fees were used to maximize the recordkeeper's fees, not to offset the expenses and burden that plan participants had to pay which violated the terms of the company's investment policy statement (IPS).

Using low cost funds

If a plan sponsor has a fund lineup made up of low cost funds, index funds, or exchange traded funds, revenue sharing payments aren't likely going to be an issue because they're not getting any because the management fees of the investment options are so low, revenue sharing would be impossible.

If you use revenue sharing, state it

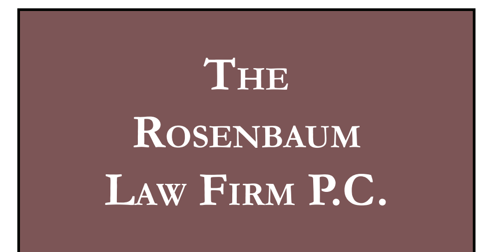
Speaking of an IPS, an IPS is used to select and replace investment options to the Plan. Having worked on many participant directed 401(k) plans, I would state that more than 95% of the 401(k) plans with an IPS have an IPS that contains no language concerning revenue sharing. I would say 95% of the Plan documents out there make no mention of revenue sharing either. As a plan fiduciary, a plan sponsors needs to what I call "paper the process" which uses resolutions, plan documents, and an IPS to document a plan sponsor's thinking in running the fiduciary process of the plan. Plan document or IPS language that states how revenue sharing will be used can go a long way in answering why plan investments were selected and what the plan fiduciaries intend to do with revenue sharing payments received.

Don't let revenue sharing cloud your judgment

Even if a plan sponsor has language in the IPS concerning the use of revenue sharing, they can't let their investment decisions be swayed by revenue sharing. Deciding which investment options should be selected involves much discussion and much consideration involving market conditions and implications. Simply using funds just because they produce revenue sharing is a lawsuit ready to happen. Plan fiduciaries have to be prudent and careful, having high expense mutual funds with the main consideration that they pay in revenue sharing is going to be a violation of their duty of prudence. Plan sponsors also have a fiduciary duty to decide which share classes of the mutual funds they offer to make sure that the most inexpensive one possible (often depending on plan size) is used. Courts in several landmark 401(k) cases such as Tibble and Tussey v. ABB look to the decision making process of the plan's fiduciaries in selecting funds. In Tussey, the Court held that the plan sponsor ABB breached their fiduciary duty of loyalty by selecting a more expensive share class when other less expensive share classes were available because the investment decisions were made in part to generate the most revenue sharing possible. ABB never made any reasonable effort to determine whether plan fees were reasonable. So plan sponsors need to be vigilant if they are using revenue sharing. Plan sponsors need a policy in place as to how revenue sharing payments are used and a policy of investment management fees/share classes. They must identify the amounts generated by revenue sharing and the investment options that pay it. Then plan sponsors must determine whether the expenses of the investment options are reasonable by benchmarking them. Prudent and vigilant plan sponsors are never liable for breaching their fiduciary duties, only the careless are.

The pendulum is swinging against revenue sharing

Thanks to fee disclosure regulations and a long time concern over plan fees, the pendulum in the marketplace and the courtroom are swinging against the use of revenue sharing in 401(k) plans. It was more than 13 years ago when I first heard of a class action lawsuit regarding revenue sharing and over time, court have started to focus on fiduciary duties and have held plan sponsors violating them by being reckless in the use of revenue sharing when they never would have been in the same trouble over a decade ago. The marketplace has gone from a dark room full of smoke and mirrors to an environment with full transparency. That is why the 401(k) marketplace has been lowering fees and shifting investments to more inexpensive investments such as index funds and exchange traded funds. The day of wine and roses are over and the days of saddling plan participants with high fee mutual funds so they can have plan expenses offset are headed that way too.



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