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Fair Revenue Sharing, Part 2

The DOL's guidance on allocating revenue

Last month's column ("Fair Revenue Sharing") described the allocation of recordkeeping costs and revenue sharing to participants' accounts. This article reviews the related guidance from the Department of Labor (DOL).

What are the criteria for allocating revenue sharing? Unfortunately, there is no specific DOL advisory. However, there is direction in an analogous situation—the allocation of expenses. In Field Assistance Bulletin (FAB) 2003-03, the DOL laid out four principles, or requisites:

• Fiduciaries must engage in a deliberative, prudent process;

• They must weigh the interests of different classes of participants and the effect the method of allocation has on those participants;

• The method must have a reasonable relationship to the services provided to the participants; and

• The fiduciaries must avoid conflicts of interest.

The first requisite—that fiduciaries engage in a deliberative, prudent process—is the requirement for any fiduciary decision. In other words, fiduciaries must engage in a thoughtful process: Gather the information they need, then make a reasonable choice.

The second is that a committee weigh the interests of different participants and the impact of the decision. While it is prudent in many cases to allocate revenue sharing on a pro rata basis, the committee should, at the least, take into account the source of the revenue sharing—who paid for it—and the consequences to the participants—who benefited from it. Fiduciaries must also consider the cost of doing a precise allocation. If a plan's recordkeeper cannot make precise allocations, the cost of the allocations, such as changing providers, could outweigh the benefit of equalizing revenue sharing—particularly where an equalized allocation would not produce a materially different result than a pro rata one.

The third principle—that the method of allocation have a reasonable relationship to the services—is more difficult to analyze. That is because many recordkeepers take the position that they receive the revenue-sharing payments from the mutual fund families for providing services to the mutual funds—for example, distribution of prospectuses, allocation of the shares among participants' accounts and so on. However, those are services to the plan, as well. Viewed in that way, where a mutual fund is paying revenue sharing to provide those services, those payments should benefit the participants who hold that mutual fund—not participants who hold other mutual funds. But keep in mind that the fiduciary process is not simply a matter of adding up the pros and cons and then making the decision that scores the most points. Instead, it involves weighing all of the relevant factors, including complexity and cost.

Conflicts of Interest

The final requisite is that fiduciaries must avoid conflicts of interest. Committee members may be invested in mutual funds or other investments that pay little, if any, revenue sharing, while rank-and-file employees may be invested more heavily in mutual funds that pay significant amounts of revenue sharing. If so, the committee members would have an obvious conflict of interest if they allocated revenue sharing to their benefit, e.g., pro rata.

The following are a couple of instances where conflicts may exist. Where a plan offers company stock, the company stock account often pays little, if anything, for the operation of the plan. In that case, the investors in the company stock account receive a "free ride," while the participants in mutual funds pay the costs of the plan. On the face of it, that seems inequitable. However, it becomes even more problematic when additional factors are added. What if the highly compensated employees and the executive group—or even committee members—are more heavily concentrated in the company stock account? A similar situation exists where a plan offers individual brokerage accounts. Are those brokerage accounts being charged their proportionate share of the costs of operating the plan?

As you can see, the allocation of revenue sharing and costs poses significant issues that must be managed through a prudent process. This is an emerging issue for plan committees.

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