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The Perils of PERA: Putting 401(k) PERAs and ERISA Budget Accounts under the Fiduciary Microscope

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This column provides a background of the mechanics of revenue sharing (payments that investment plan options make to third party administrators (TPAs) to compensate TPAs for their recordkeeping services), then discusses the recent Department of Labor guidance, and lastly discusses plan fiduciary considerations in setting up and monitoring such "excess" accounts.

401(k)[1] plan sponsors often delegate oversight of their defined contribution plans to a select group of individuals, very often a group of employees who form a plan committee to oversee the plan and ensure that the plan complies with the Employee Retirement Income Security Act of 1974, as amended (ERISA) and the Internal Revenue Code of 1986, as amended. The plan fiduciaries are typically tasked with a number of important responsibilities, including the job of providing oversight of plan administrative and investment matters.[2] Foremost among these oversight responsibilities is the obligation to make sure that third party administrators (TPAs) that provide recordkeeping and other administrative services to the plan—like the well-known TPAs, which include Vanguard, Fidelity, ING, MassMutual, Schwab, and Principal, to name a few—receive no more than reasonable fees for their services. As is well known among plan fiduciaries who take their roles seriously, when a 401(k) plan invests in an investment fund, the investment manager of the fund often shares a portion of the revenue it receives from the 401(k) plan with the 401(k) plan's TPA as a fee for recordkeeping

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services performed by the TPA. The portion of the revenue that is shared with the TPA (*i.e.*, the revenue sharing) must be taken into account when the plan fiduciaries determine whether the TPA's compensation is reasonable. Sometimes, particularly in an appreciating market environment, the revenue shared with the TPA results in the TPA receiving unreasonable (*i.e.*, excess) fees.

For several reasons, including the significant increase in 401(k) fee litigation directly challenging the reasonableness of fees received by a TPA, many plan fiduciaries are asking their TPAs to take steps to control the amount of revenue they are receiving. One such practice involves the establishment of an account that can made be available to the plan sponsor to reimburse the plan sponsor for certain plan expenses as an offset to the excess revenue collected by the TPA. Despite the seeming proliferation of this practice in the marketplace over the past 10 years, the fact remains that very little guidance has been offered by the regulatory authorities in regard to this practice. As a result, a cautious plan fiduciary would be wise to tread carefully in this area. To address some of the concerns of plan fiduciaries, the Department of Labor (DOL) recently released an Advisory Opinion regarding this practice. Because of the importance of this DOL guidance and the ongoing appreciation of the equity markets causing even more revenue to flow to TPAs, this column discusses the good, the bad, and the ugly of using excess accounts (sometimes referred to as an "ERISA Excess" or "ERISA Budget" Account or "Plan Expense Reimbursement Account" (PERA)). This column first provides a background of the mechanics of revenue sharing, then discusses the recent DOL guidance, and lastly discusses plan fiduciary considerations in setting up and monitoring such "excess" accounts.

So Just What Is Revenue Sharing?

Revenue sharing is a term used to generally describe payments that investment plan options (typically mutual funds) make to TPAs to compensate TPAs for their recordkeeping services. Participants in retirement plans typically invest their account balances in investments such as mutual funds, where the funds charge the participants a fee for the costs of maintaining the funds. This fee (often known as a management fee) is assessed as a percentage of the participants' assets that are invested in the specific fund. The TPA then receives a portion of the management fees and such payments are generally called "revenue sharing" fees. These payments include Securities and Exchange Commission Rule 12b-1 fees and other shareholder and administrative service fees.

Compensating TPAs based on a percentage of plan assets is something of an awkward arrangement, borne of marketplace developments that have generally taken place over the past two decades whereby recordkeeping services have been "bundled" (or combined) with other

services, like investment management services. Despite the bundling of the fees, TPAs in actuality only need a fixed amount to provide their services (*e.g.*, an estimated flat dollar amount or a per participant amount, taking into account various factors of recordkeeping the plan, including total assets, average account balance, and other administrative support that may relate to how decentralized the plan sponsor is in relation to the plan). Obtaining this amount—the fixed amount the TPA needs to record-keep the plan at an acceptable level—is oftentimes not readily available to the typical plan sponsor. And, making the job even more difficult for the plan fiduciary, this amount is even harder to discern when the TPA is also providing investment management services, whereby the split between the gross investment management expense and the recordkeeping revenue sharing component is perhaps somewhat arbitrarily set by the two-hatted TPA/investment manager.

In any case, under a revenue sharing structure where the TPA is paid a percentage of plan assets, the amount of fees the TPA receives is dependent on the asset level in the plan. In some cases, therefore, particularly in a rising market environment, the TPA might receive revenue sharing payments in a given time period in excess of the actual cost to the TPA for servicing the plan. In such a case, the difference is additional profit to the TPA and is generally known as “excess revenue sharing.”

Impact of ERISA Section 408(b)(2) Fee Disclosure; Alternative Responses

For several years, culminating with the Department of Labor finalizing the ERISA Section 408(b)(2) fee disclosure regulations in 2012, many plan fiduciaries began to question the revenue sharing payments that their TPAs were receiving in connection with providing recordkeeping and administrative services to their plans. Plan fiduciaries began to look for ways to recoup or reduce some of the excess fees TPAs were retaining. When looking to recoup or reduce excess revenue sharing, plan fiduciaries have a number of options to choose from to address this concern. For example, one alternative for reducing revenue sharing is for the plan sponsor to move its 401(k) plan assets from retail investment funds or other funds that may have relatively high investment management fees to funds with lower investment management fees (such as institutional investment funds). A variation on this theme is fee “leveling” where much, if not all, of the plan investments contribute an identical amount towards the recordkeeping fee. Another option might be to negotiate a fixed administrative fee and move away from revenue sharing altogether. In regard to this latter alternative, plan fiduciaries must then consider whether making a low-balance participant pay the same as a high-balance participant is unfair. If so, yet another version of this alternative is to charge participants in two parts: a percentage of assets up to a certain amount, and then a flat fee.[3]

Reimbursement Account Solution

Among these alternatives is the reimbursement account. This alternative is a contractual agreement between the plan sponsor and the TPA in which the TPA agrees to set aside a percentage of the excess revenue sharing amounts it receives for use by the plan sponsor. Deposits into such accounts can be made monthly or quarterly or at another appropriate interval. The plan sponsor can then use the amounts to pay for additional reasonable and necessary plan expenses (for example, costs for participant communication and education, certain plan amendments, nondiscrimination testing, determination letter requests, plan accounting audits, and Form 5500 preparation).

Importantly, if a plan sponsor elects to set up a revenue sharing arrangement, the arrangement is typically set up in one of two ways. One version is generally known as an ERISA Budget Account (also sometimes referred to as an ERISA Expense Account or ERISA Excess Account) and an alternative version is generally known as a Plan Expense Reimbursement Account (also referred to as a Pension Expense Reimbursement Account or PERA). While not all TPAs use the same vernacular, and the regulations actually do not use either appellation, we would generally draw the distinction as follows: In the case of an ERISA Budget Account, the TPA deposits excess revenue sharing amounts into an allocated account within the 401(k) plan's trust, which is then used by the plan sponsor to pay reasonable and necessary plan expenses. Any amounts left over at the end of the year, or at some point soon thereafter, are generally allocated among participant accounts.[4] Alternatively, with a PERA, the TPA retains the revenue sharing payments in its general assets and the amounts in question are credited to a hypothetical bookkeeping account, which is maintained by the TPA. Similar to an ERISA Budget Account, PERA amounts can be used to offset the expense of plan administration and the employer can direct the TPA to use the amounts to pay reasonable and necessary plan expenses. However, with a PERA, it is possible that there is no allocation to the participants if amounts are left unspent.

Prior to 2013, the DOL had issued little guidance regarding either type of arrangement, but that changed in July 2013 with DOL Advisory Opinion 2013-03A.

Department of Labor Advisory Opinion 2013-03A

Are Revenue Sharing Amounts Plan Assets?

In July 2013, the DOL issued guidance on revenue sharing payments in DOL Advisory Opinion 2013-03A (the Opinion). The Opinion addressed an arrangement whereby a plan TPA (Principal Life Insurance Company) received revenue sharing payments in connection with investments by

the plan and, while the TPA retained the payments in its own general account, the TPA had an agreement with some plan sponsors to record bookkeeping credits based on these amounts, which could then be applied at the direction of the plan sponsor to pay certain plan expenses or to be deposited directly into participant accounts (essentially a PERA). In the TPA's request for guidance, the TPA specifically asked the DOL to clarify if such amounts constituted plan assets. This was an important clarification for TPAs because if revenue sharing payments held by a TPA are treated as plan assets before they are used for the benefit of the plan, then the TPA could be treated as a fiduciary of the assets in the PERA and the TPA would then be violating the prohibited transaction rules by commingling the revenue sharing payments with the TPA's general assets.

In addressing the question of whether such amounts were plan assets, the DOL first noted that ERISA does not define plan assets in regard to PERAs and that applicable DOL regulations identifying plan assets do not address this specific issue.[5] Instead, the DOL relied on a previous Advisory Opinion which identified ERISA plan assets on the basis of ordinary notions of property rights.[6] In DOL Advisory Opinion 94-31A, the DOL stated that plan assets generally included any property, tangible or intangible, in which the plan had a beneficial ownership interest.[7]

In the Opinion, the DOL went on to state that "nothing in the circumstances described above…would lead us to conclude that amounts recorded in the bookkeeping account as representing revenue payments are assets of the client plan before the plan actually receives them."[8] The DOL stated that where the TPA keeps the revenue sharing amounts with its own general assets, such amounts are not considered plan assets, even if the TPA sets the amounts aside for the ease of administration of the plan. The DOL further reasoned that merely crediting revenue sharing amounts to a PERA maintained by the plan's TPA does not create a beneficial interest in the amounts for the plan because the actual dollars remain with the TPA as part of its general assets and therefore the amounts do not belong to the plan.

On the other hand, if the TPA places the amounts in an account that is only for the benefit of the plan, the amounts are considered plan assets. In the Opinion, the DOL stated that revenue sharing payments would generally be considered to be plan assets if the revenue sharing payments were held in a trust on behalf of the plan or the revenue sharing payments were held in a separate account with a bank or third party in the name of the plan.

The DOL next concluded that it is possible, however, that revenue sharing payments received by TPAs be deemed plan assets even when not placed within a specified account, when it stated "[however,] the plan's contractual right to receive the amounts agreed to with [the TPA], or to have them applied to plan expenses, would be an asset of the plan."[9] The DOL reasoned that if it is specifically indicated in the agreement between the plan sponsor and the TPA that the funds be separately

maintained then the funds belong to the plan.[10] However, the terms of the contract between the TPA and the plan at issue in the Opinion did not specifically require revenue sharing payments to be segregated for the benefit of the plan.

Fiduciary Considerations

While the Opinion was generally good news for plan sponsors, as it provided plan fiduciaries with comfort that a PERA arrangement with a TPA does not constitute plan assets giving rise to various ERISA requirements, the DOL spent a significant amount of time making clear that such arrangements require a heightened level of fiduciary diligence, including vigilant oversight of the fees their TPAs are charging in general and the structure of any revenue sharing arrangement.

The Opinion emphasized that, regardless of whether or not the amounts constituted plan assets, such revenue sharing arrangements are still subject to certain requirements under ERISA including Section 408(b)(2)'s requirement of a reasonable contract and arrangement for services that would otherwise be prohibited between a plan and a party in interest. Plan fiduciaries must therefore ensure that the compensation the plan pays directly or indirectly to the TPA is reasonable, and in their analysis, must take into account all fees or compensation received by the TPA in connection with the investment of the plan assets, including revenue sharing payments.

The DOL stated that ERISA's general prudence requirements apply to such revenue sharing arrangements and that plan sponsors must continue to act in the best interests of the plan participants while negotiating such an arrangement. Specifically, the plan fiduciary must "understand the formula, methodology and assumptions used" by the TPA when crediting the reimbursement account with such revenue sharing payments.[11] The DOL also indicated that plan sponsors must be capable of periodically monitoring the revenue sharing arrangement and the TPA's services to ensure that the revenue owned to the plan is calculated correctly and credits are applied properly, therefore making regular independent audits of reimbursement accounts critical.

Regardless of whether or not the revenue sharing payments would or would not be considered plan assets under DOL guidance, plan sponsors must ensure that they have enough information about the revenue sharing arrangement and fees being paid to satisfy ERISA's fiduciary standards.

PERAs/ERISA Budget Accounts: The Good, the Bad, and the Ugly

From a plan fiduciary's standpoint, recouping a portion of the excess revenue sharing payments from the plan's TPA can provide a significant economic benefit to the plan and its participants and seems to be an

effective way to satisfy the plan fiduciary's ERISA fiduciary responsibilities. After all, excess revenue is being recaptured and the money can be put to good use. For example, reasonable and necessary plan expenses that might have otherwise been charged to participant accounts or paid out of the company's general corporate assets can now be paid from the recouped revenue sharing amounts instead. Additionally, such expenses that might have otherwise been paid out of the plan's forfeiture account can be paid with recouped revenue sharing instead, making the forfeitures available to reduce employer contributions. As plan assets grow, the amount available in the account will generally grow as well; therefore, both ERISA Budget Accounts and PERAs can provide a significant additional source of payment for plan expenses and a self-regulating way to protect against excess revenue collection by the TPA.

However, there can be concerns with these sorts of arrangements as well. First, the PERA/ERISA Budget structure very often starts out of necessity, out of an acknowledgement that the TPA is collecting "too much" in revenue sharing fees. Whether this acknowledgment leads to increased fiduciary risk is something of an unknown. As a result, some of the other solutions, including those outlined earlier in this column, may keep TPA fees to the appropriate level while avoiding the notion that excess revenue sharing exists. Only after analyzing (and documenting) all of the other options should the reimbursement account be established.

Further, even when a reimbursement account is a necessity, plan fiduciaries are well advised to avoid a situation where the reimbursement account continues to grow as overall assets increase, particularly if there is more in the reimbursement account than what the plan fiduciaries otherwise could reasonably spend. And, if amounts ultimately are reallocated to participants, plan fiduciaries should consider the various methods that may be appropriate (per person; pro-rata based on account balance; and whether all participants should benefit equally or whether those in funds that share more revenue should receive a greater proportion of the re-allocation). Plan fiduciaries should also consider that there will be winners and losers (although the amounts on an individual basis will typically be immaterial); the accounts that have deductions initially for the revenue sharing payments will not be reimbursed dollar for dollar when there is a reallocation.

Moreover, because amounts credited to a PERA are held outside the plan's trust and there is more flexibility built into the process, plan fiduciaries should be particularly wary of the types of expenses that are being reimbursed through the PERA and should look askance at any forfeiture provisions that apply to the excess amounts. Because the terms of a PERA are generally contractual between the plan sponsor and the TPA, the plan sponsor and TPA should execute a written agreement setting forth how the amounts will be credited to the account and used to pay plan expenses. Many TPAs will include language in their service agreements that, for example, require the PERA amounts be used within a certain amount of time after the end of the plan year (*e.g.*, 90 days). The DOL stated in the Opinion that because PERA amounts do not constitute

plan assets, the amounts may be carried on indefinitely. Therefore, plan fiduciaries should ideally ensure that the PERA amounts do not expire and should investigate whether it is possible to have the amounts roll-over from year to year if not used. Additionally, a prudent plan fiduciary should pay carefully attention to contractual terms that address what happens to the PERA when the relationship with the TPA is terminated. The TPA may include language in its service agreement that if the plan discontinues the services of the TPA, the PERA may be forfeited and the TPA would then retain the remaining revenue sharing amounts in the PERA. This could lead the plan to leave a significant amount of money on the table, therefore plan fiduciaries should ask that language to this effect be removed from their agreement or substantially modified.

In sum, when a TPA is receiving “excess” revenue from the funds, plan fiduciaries must act quickly to reduce the excess. While there are several options that can be used to address this concern, an “excess” reimbursement account like a PERA or ERISA Budget Account can be tempting because of the apparent benefits of collecting excess funds. However, these accounts carry with them their own level of risks that are not yet fully understood. While the DOL recently provided guidance in this area, it may be some time before plan fiduciaries see whether they are creating additional legal risks relating to the creation of these accounts. At the very least, the DOL Opinion, contractual provisions, and plan documents should be reviewed to determine the extent of these risks.

Importantly, plan sponsors should engage legal counsel to evaluate any revenue sharing arrangement and should ensure that all aspects of the arrangement are properly documented. Plan sponsors and fiduciaries should review current revenue sharing arrangements to ensure that such arrangements are sound and providing the best protection for the plan and plan participants. Legal counsel can help set the parameters both for how to structure the account and how the TPA will allocate the amounts credited to the account. As plan sponsors and fiduciaries consider their options, the following checklist may be a useful starting point:

1. Decide if a reimbursement account is for you: As mentioned above, reimbursement accounts are only one alternative to address excess revenue sharing. Plan fiduciaries, for example, may decide that it is more prudent to move to funds with lower investment fees or to charge each participant’s account a flat dollar amount.

2. Make sure that you understand the mechanics of your reimbursement account: Many TPAs use the terms ERISA Budget Account and PERA interchangeably, therefore, it is critical that a plan sponsor understand the setup of their account.

3. Make sure that the terms of the agreement governing your reimbursement account are favorable to your plan and the

plan participants: Plan sponsors should ensure that they are maximizing the recoupment options.

4. Review your plan document and consider whether plan amendments are needed to reflect the operation of your reimbursement account.

5. Be prepared with a list of expenses you plan to pay with the reimbursement account amounts: Plan sponsors should be prepared to use the amounts allocated to the accounts, especially where the money may be lost at the end of the plan year.

Whether or not a plan sponsor currently has a revenue sharing arrangement with a TPA, in light of the enactment of the ERISA Section 408(b)(2) fee disclosure regulations and the recent DOL guidance on revenue sharing arrangements in the form of Advisory Opinion 2013-03A, now is the time for plan sponsors and fiduciaries to assess (or reassess as the case may be) their current fee arrangements and revenue sharing account structure with their ERISA legal counsel.

Notes

1. This column uses the term "401(k)" loosely. The same concerns apply to 403(b) and other plans subject to the Employee Retirement Security Act of 1974, as amended (ERISA).

2. Those companies that have not properly established such a group, like a 401(k) committee, with legal counsel providing appropriate oversight, are well advised to reconsider their structure, in order to minimize the chances that unsuspecting owners and officers are assessed personal liability in case of 401(k) errors.

3. Plan sponsors are also concerned about the different level of revenue sharing that may apply to differing funds. In that case, one participant may be subsidizing plan costs at a higher level than another plan participant.

4. The position that amounts in ERISA Budget Accounts must be allocated by the end of the plan year is based on Internal Revenue Service (IRS) guidance implicitly disfavoring "suspense" accounts beyond a single plan year. IRS Newsletter, *Retirement News for Employers*, Volume 7 (Spring 2010).

5. The Department of Labor regulations identifying plan assets is found at 29 C.F.R. 2510.3-101.

6. Dept. of Labor Advisory Op. 94-31A (September 1994).

7. *Id.*

8. Dept. of Labor Advisory Op. 2013-03A (July 2013).

9. *Id.*

10. *Id.*

11. *Id.*

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