

Fees, Expenses and Revenue Sharing: Regulation, Litigation, Legislation and Best Practices

presented by
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♦
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Plan Expenses and Compensation

The trend is towards full disclosure—at both the plan and participant level.

- disclosure to fiduciaries and participants
- disclosure by providers and advisers
- disclosure of costs
- disclosure of compensation and revenue sharing (“direct” and “indirect”)

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Expenses: Issues

The fiduciary concerns:

- Are the expenses reasonable?
- Is the compensation reasonable?
- Are there conflicts?

Note regarding benchmarking: quantitative versus qualitative.

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Plan Expenses: Prohibited Transactions

The Law:

Under ERISA §408(b)(2), the prohibited transaction rules permit:

"Contracting or making reasonable arrangements with a party in interest for . . . services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor."

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Expenses: Fiduciary Responsibility

The Law:

As explained by the DOL, the primary plan fiduciaries are required to know and evaluate the compensation paid:

" . . . the responsible Plan fiduciaries must assure that the compensation paid **directly or indirectly** by the Plan to [the service provider] is reasonable, taking into account the services provided to the Plan as well as any other fees or compensation received by [the service provider] in connection with the investment of Plan assets."

continued . . .

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Expenses: Fiduciary Responsibility

The Law:

" . . . The responsible Plan fiduciaries therefore **must obtain sufficient information** regarding any fees or other compensation that [the service provider] receives with respect to the Plan's investments . . . **to make an informed decision** whether [the service provider's] compensation for services is no more than reasonable." [DOL Advisory Opinion 97-15A.]

Note: Fiduciary duty to investigate.

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Claims in Class Action Litigation

The Law:

In one of the current class action lawsuits, the complaint asserted, among other things:

Defendants breached their fiduciary obligations to the Plan . . . by, among other conduct to be proven at trial, one or more of the following acts:

- Failing to monitor the fees and expenses paid by the Plan and, by such failure, causing and/or allowing the Plan to pay fees and expenses that were . . . unreasonable . . . ;

continued . . .

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Claims in Class Action Litigation

The Law:

- Failing to inform themselves of, and understand, the various methods by which vendors in the 401(k) industry collect payments and other revenues from 401(k) plans;
- Failing to establish, implement, and follow procedures to properly and prudently determine whether the fees and expenses paid by the Plan were reasonable and incurred solely for the benefit of Plan participants; . . .

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Recommendations on Costs and Revenues

The Advisory Council makes the following recommendations in an effort to further educate plan sponsors and fiduciaries:

- Plan sponsors should obtain all information on fees and expenses as well as revenue sharing arrangements with each investment option.

continued . . .

ERISA Advisory Council Report of the Working Group on Plan Fees and Reporting on Form 5500

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Recommendations on Costs and Revenues

- Plan sponsors should also determine the availability of other mutual funds or share classes within a mutual fund with lower revenue sharing arrangements prior to selecting an investment option.
- Plan sponsors need to be aware that with asset-based fees, fees can grow just as the size of the asset pool grows, regardless of whether any additional services are provided by the vendor, and as a result, asset-based fees should be monitored periodically.

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Risk Management Lessons from Litigation

The Caterpillar settlement for \$16.5 million included the following provisions:

- annual disclosures to participants of fees and expenses (expressed as dollars);
- not including retail mutual funds in the plan's core line-up;
- stop paying recordkeeping fees as a percent of assets.

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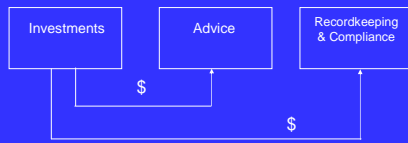
Lessons from Litigation

The Hartford settlement and the role of the RIA:

- What is the role of the RIA?
- Service agreements as risk management tools.

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What Should Fiduciaries Do?



- Once the expenses and revenues are properly allocated, plan sponsors need to evaluate their reasonableness.
- Expense recapture.
- Share classes.

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Risk Management

Issues:

- Allocate
- Benchmark
- Negotiate

Note: Benchmarking (against appropriate peer groups) is a fundamental part of a prudent process.

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Expenses: ERISA Budget Accounts

Issues for these accounts:

- plan asset?
- plan document provisions?
- permitted expenses?
- allocation to participants?

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Expenses: DOL Activity

DOL activity:

- Revisions to Form 5500, Schedule C (reporting).
- Point-of-sale disclosure to fiduciaries for advisers and providers (408(b)(2) project).
- Revisions to 404(a) regulation (participants).

This shifts the burden from fiduciaries to the 401(k) industry to disclose, but not to evaluate.

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Schedule C for 2009 Form 5500

The DOL has released the 2009 Form 5500 package. The new Schedule C—for plans with 100 or more participants—requires reporting by plan sponsors of direct and indirect revenues received by service providers.

- Direct compensation
- Indirect compensation: eligible and ineligible

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Schedule C

Definition of compensation:

For Schedule C purposes, reportable compensation includes money and any other thing of value (for example, gifts, awards, trips) . . .

. . . received by a person, directly or indirectly, from the plan (including fees charged as a percentage of assets and deducted from investment returns) . . .

Note: The same definition was used for 408(b)(2) disclosure purposes.

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Part I	Service Provider Information (see instructions)
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1. Information on Persons Receiving Only Eligible Indirect Compensation

b If you answered line 1a "Yes," enter the name and EIN or address of each person providing the required disclosures for the service providers who received only eligible indirect compensation. Complete as many entries as needed (see instructions).

(b) Enter name and EIN or address of person who provided you disclosure on eligible indirect compensation

2. Information on Other Service Providers Receiving Direct or Indirect Compensation. Except for those persons for whom you answered "yes" to line 1a above, complete as many entries as needed to list each person receiving, directly or indirectly, \$5,000 or more in total compensation (i.e., money or anything else of value) in connection with services rendered to the plan or their position with the plan during the plan year. (See instructions).

(a) Enter name and EIN or address (see instructions)

(b)	(c)	(d)	(e)	(f)	(g)	(h)
Service contract	Relationship to employer, employee or person who is a party-in-interest	Enter direct compensation paid by the plan. If none, enter -0-	Did service provider receive indirect compensation? (sources other than plan or plan sponsor)	Include indirect compensation for the plan received the required disclosures?	Enter total indirect compensation received by service provider. If eligible indirect compensation for the plan which you answered "yes" to in question (f), if none, enter -0-	Did the service provider give you a formula or an amount or an estimated amount or an

Written disclosures must also be given that describe:

Schedule C

Part I Service Provider Information (continued)

3 If you reported on line 2 receipt of indirect compensation, other than eligible indirect compensation, by a service provider, and the service provider is a fiduciary or provides contract administrator, consulting, custodial, investment advisory, investment management, broker, or recordkeeping services, answer the following questions for (a) each source from whom the service provider received \$1,000 or more in indirect compensation and (b) each source for whom the service provider gave you a formula used to determine the indirect compensation instead of an amount or estimated amount of the indirect compensation. Complete as many entries as needed to report the required information for each source.

(a) Enter service provider name as it appears on line 1	(b) Service Codes (see instructions)	(c) Enter amount of indirect compensation
(d) Enter name and EIN (address) of source of indirect compensation	(e) Describe the indirect compensation, including any formula used to determine the service provider's eligibility for or the amount of the indirect compensation.	

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Schedule C

Failure to Provide Information:

If a service provider fails to provide the information needed to complete the Schedule C, the plan must report that information to the DOL on the Schedule C.

Part II Service Providers Who Fail or Refuse to Provide Information

4 Provide, to the extent possible, the following information for each service provider who failed or refused to provide the information necessary to complete this Schedule.

(a) Enter name and EIN or address of service provider (see instructions)	(b) Nature of Service Code(s)	(c) Describe the information that the service provider failed or refused to provide

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408(b)(2) Proposed Regulation

The proposal applies to anyone who:

- is a fiduciary under ERISA or the Investment Advisers Act of 1940;
- provides these services: banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities or other investment brokerage, or third party administration; or

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408(b)(2) Proposed Regulation

- provides these services and receives indirect compensation: accounting, actuarial, appraisal, legal or valuation.

Possible effective date: for new plan clients.
for existing plan clients.

Potential legislation

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Contract or Arrangement

"Covered" service providers must have a contract or arrangement with the plan and satisfy the following requirements:

- the terms must be in writing;
- the terms (including any extension or renewal) must disclose to the best of the provider's knowledge the following information and . . .

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408(b)(2) Proposed Regulation

- . . . must include a representation that, before the arrangement was entered into, all the information was given to the responsible plan fiduciary:
 - a list of the services provided, and
 - for each service,
 - the compensation to be received, and
 - the manner of receipt.
 - information about potential conflicts of interest

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Conflicts of Interest: Proposal

Disclosure: Whether the service provider (or an affiliate) will provide any services to the plan as a fiduciary either within the meaning of ERISA section 3(21) or under the Investment Advisers Act of 1940.

Note: Potential Impact on RIAs and registered representatives/broker-dealers.

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Conflicts of Interest

Whether the service provider (or an affiliate) will be able to affect its own compensation or fees, from whatever source:

- without the prior approval of an independent plan fiduciary;
- if so, a description of the nature of such compensation.

Note regarding DOL Advisory Opinion 97-16A ("Aetna" Opinion).

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Information for Reporting and Disclosure

The terms of the contract or arrangement must require that the service provider disclose:

- all information related to the contract or arrangement and any compensation or fees received thereunder;
- that is requested by the responsible plan fiduciary or plan administrator in order to comply with the reporting and disclosure requirements of ERISA.

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Participant Investment Advice

The new proposed regulation on participant investment advice requires disclosure of the adviser's (and any affiliate's) compensation.

How does that affect independent RIAs?

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Participant Investment Advice

- "Pure" level fee advice.
- Conflicted investment advice.
- Disclosures to participants.
- 406(b) prohibited transactions.

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Expenses: The Right Answer

The final word . . .

Increased disclosure of compensation will enable fiduciaries to better evaluate the cost and value of the plan's services. However, it will place a burden on fiduciaries to review and understand the information received.

It will also better enable the competitive marketplace to work and, as a result, should ultimately reduce the costs—at least for some plans.

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