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MAGAZINE

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Just out of Reish:401(k) Freeloaders

Joseph Ciardiello

Considerations about non-revenue-sharing investments

I am concerned that plan sponsors are taking a risk in how they pay for their plans. Many 401(k) plans use revenue sharing to pay for their operations. For example, revenue sharing paid by a plan's mutual funds often covers the cost of the recordkeeper/provider and sometimes the cost of the consultant/adviser. Since there is no such thing as a free lunch, the mutual funds that pay revenue sharing usually have higher expenses. In other words, the money that pays plan costs comes from somewhere, and that "somewhere" is the participants who invest in those mutual funds. If all of the mutual funds pay revenue sharing, and if they all pay approximately the same amounts, fiduciaries can take the view that participants are being treated relatively fairly. However, that conclusion gets dicey when some pay revenue sharing and others do not, or when the payments are materially different.

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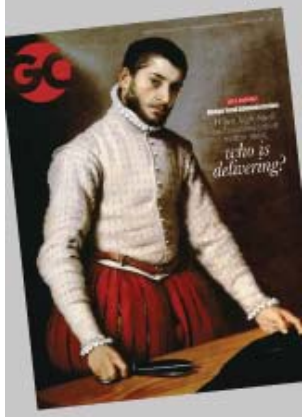

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MEDIA KIT

My column this month is about two types of investments that usually don't share in the cost of the plan: company stock funds and individual brokerage accounts. The participants who invest in those alternatives don't bear the extra expense for revenue sharing. To dramatize my point, I refer to this practice as "401(k) freeloading"—even though, to be fair, it's not the fault of those participants but instead results from how the fiduciaries structured the plan.

Thus, the fundamental question is this: Is it fair—or, more importantly, legal—for participants who invest in company stock or brokerage accounts to be in the plan for free while those who invest in mutual funds are charged higher expenses to pay for the plan? Each plan committee will have to decide for itself about fairness. But what about legality? Unfortunately, there is no law that applies directly to the subject.

Instead, the available guidance, which is limited, states that these are fiduciary decisions and that fiduciaries must act "prudently" in making the decisions. This applies to the allocation both of expenses and of revenue sharing.

What does "prudent" mean in this context? The best I can tell you is that committees need to affirmatively make decisions about allocating revenue sharing and expenses, and to do that they must engage in a prudent process. A prudent process calls for fiduciaries to collect the relevant information, evaluate it—and ask for advice, if needed—then reach a reasoned decision. That's the theory. What about the practice?

The first step in the prudent process—gathering the necessary information—requires that a committee calculate the total cost of the plan and the revenue sharing paid by the investments, including any credits given to the recordkeeper for investments managed by affiliates. Then, the committee needs to determine how those costs are paid. Is the revenue sharing paying for the plan? Are some participants being charged proportionately more than others because of the investments they choose—e.g., more expensive revenue-sharing funds? If the fiduciaries do that analysis and reach a reasoned decision, they should be protected.

But what is a "reasoned" decision in that context?

What if, say, the committee's investigation reveals that one-third of the plan money is invested in company stock and individual brokerage accounts that do not pay revenue sharing and two-thirds is invested in mutual funds that do pay revenue sharing? It may be hard to justify having some of the participants carry the cost of the plan for the benefit of those who pay nothing. There is a point at which 401(k) "freeloading" produces an imprudent result. Unfortunately, we don't know where that

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line falls. However, the lack of specific guidance is not an excuse for fiduciaries to ignore the issue. The general guidance is clear: Committees must engage in prudent processes to make their decisions.

The moral of this story is that, while there isn't much guidance, we know that the allocation of revenue sharing and expenses is a fiduciary decision. We also know that fiduciary decisions must be made prudently, which means that committees need to engage in a prudent process. Now is the time to take those steps.

Fred Reish is chair of the Financial Services ERISA team at the law firm of Drinker, Biddle & Reath LLP. A nationally recognized expert in employee benefits law, he has written four books and many articles on ERISA, IRS and DOL audits, and pension plan disputes. Follow Fred on Twitter at @FredReish, and visit his blog at fredreish.com.

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