ERISA Accounts and Fiduciary Duties

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Judicial precedent and regulatory initiatives have driven plan sponsors and their advisors to develop innovative ways to meet ERISA-mandated duties to their plans and participants with respect to the revenue sharing received by recordkeepers from mutual funds. ERISA requires that plan fiduciaries evaluate the reasonableness of fees paid to plan service providers, including indirect fees, such as revenue sharing. So-called "ERISA accounts" are one means of dealing with this issue, but their advantages must be balanced against the fiduciary duties and administrative burdens associated with them.

By recapturing fees, ERISA accounts help solve the issue that arises when a recordkeeper receives revenue sharing that exceeds the fee stated in its contract with the plan. These accounts can be set up as either hypothetical bookkeeping accounts, sometimes referred to as a "bookkeeping spending account" (BSA), or as actual asset-backed plan accounts, known as "ERISA budget accounts." Very large plans may be less interested in establishing ERISA accounts, because they tend to have less revenue sharing, given the availability of alternative investments, such as separate accounts and collective trusts. However, due to the unpredictability of revenue sharing payments from year to year, best practice suggests that most plan sponsors consider the use of some kind of fee recapture account.

Bookkeeping Spending Accounts

In the case of a BSA, which may be called different names, such as a plan expense reimbursement arrangement, or PERA, the recordkeeper typically credits any revenue sharing in excess of its stated fee to a notional account maintained on its books. For example, if a recordkeeper receives $9,000 in revenue sharing on behalf of a plan client, but its stated fee is only $7,500, the excess $1,500 would be credited to a BSA. This credit then may be utilized, as directed by the plan sponsor, to pay the plan's expenses, including fees payable to service providers other than the recordkeeper, such as accountants, actuaries, consultants, or attorneys.

Under this arrangement, the actual revenue sharing dollars remain with the recordkeeper as part of its general assets, and no amounts are set aside or held in escrow or trust for the benefit of the plan. As a result, the bookkeeping account is no more than an unsecured promise by the recordkeeper to pay plan expenses. If the recordkeeper were to become insolvent, the plan would be treated like any other unsecured creditor of the recordkeeper. This type of account may carry over from year to year; however, if the plan terminates its contract with the recordkeeper, the account could be forfeited, in which case the recordkeeper would retain the remaining revenue sharing that generated the account.

Last year, the Department of Labor issued Advisory Opinion 2013-03A clarifying that revenue sharing payments received by a recordkeeper are not plan assets subject to ERISA fiduciary duties where the plan only receives credits which are calculated with reference to the revenue sharing rather than cash or hard assets. The Advisory Opinion also provided guidance as to the fiduciary due diligence needed to set up a BSA. Thus, prudence requires the plan sponsor to negotiate a reasonable formula and methodology for crediting revenue sharing amounts to the account and for paying such amounts to the plan or its service providers. This means that the plan sponsor must understand these mechanics, as well as any assumptions used by the recordkeeper in determining credits to the BSA.

Once it is set up, the plan sponsor must periodically monitor the recordkeeper's performance under the arrangement, including its calculations of revenue sharing credits and the application of those credits for the plan's benefit. Credits to the BSA should match the revenue sharing disclosed by the recordkeeper pursuant to the obligations imposed on plan service providers under the recent 408(b)(2) regulations. If it does not have the experience to oversee the recordkeeper and monitor its determinations under the account formula, the plan sponsor may need to hire an independent fiduciary to review and monitor the BSA.

Under the 408(b)(2) regulations, a service contract or arrangement violates the prohibited transaction rules unless "no more than reasonable compensation is paid for the services." The compensation subject to this rule includes amounts paid from a BSA, regardless of whether it is considered to be a plan asset. A plan sponsor will need to be especially careful with regard to contractual provisions determining who will be entitled to unused credits in the event the contract is terminated and whether credits can be paid to the plan and allocated to participant accounts.

Plan sponsors also should ensure that the process for paying plan expenses under a BSA is consistent with the plan documents. Generally speaking, the plan document specifies the persons who have the authority to approve each plan expense. Under a BSA, however, this power may be held by the recordkeeper and, if so, there should be a delegation of authority to the recordkeeper in accordance with the plan's procedures. Advisory Opinion 2013-03A indicates that

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whoever makes the decisions regarding payment of plan expenses from the BSA must assure itself that the recipients receive no more than reasonable compensation from the plan.

ERISA Budget Accounts

An ERISA account also can be set up as an actual plan account, often referred to as an "ERISA budget account." This type of ERISA account involves the actual transfer of funds to a separate account established within the plan trust so that these funds become plan assets. In contrast to BSAs where only revenue sharing in excess of the recordkeeper's fee is credited, all revenue sharing payments (and not just the excess) can be deposited into an ERISA budget account or the arrangement can be structured so that the recordkeeper only deposits the excess revenue sharing into the account. Once the deposit is made, the ERISA budget account may be used to pay the recordkeeper's own service fees or the fees of other service providers. However, at the end of the plan year, any unused amounts in the ERISA budget account must be allocated to plan participants in accordance with IRS Revenue Ruling 80-155.

Although Advisory Opinion 2013-03A was issued with respect to a BSA, the principles discussed above regarding a fiduciary's duties in implementing and monitoring a BSA also apply to ERISA budget accounts. Accordingly, a plan fiduciary must understand the details of the ERISA budget account, including its allocation formula, methodology, and assumptions, and be capable of periodically monitoring the account to assure that its terms are being carried out correctly and that required amounts are being paid to the various plan providers.

Since an ERISA budget account is required to allocate any unused funds to participants each year, the plan document should state how these amounts will be allocated. In addition, the amounts deposited in such an account will need to be invested in some fashion. The plan document also should be reviewed to ensure that the plan's trustee or other fiduciary will be directed or have the ability to invest the account in cash or another appropriate short-term investment. A plan amendment may be necessary where the plan document does not include provisions relating to ERISA budget accounts.

Since amounts deposited in an ERISA budget account are plan assets, they need to be reflected in the plan's financials and reported on Form 5500. Plans with 100 or more participants must report their indirect and direct compensation payable to service providers separately. If the funds held in an ERISA budget account are used to pay recordkeeping fees or fees of another provider, all payments to the providers should be viewed as *direct* compensation paid from the plan itself, since these funds are clearly plan assets. In contrast, if the amounts credited by a recordkeeper under a BSA are used to pay another provider, the payment from the recordkeeper to the other provider should be viewed as *indirect* compensation for reporting purposes.

Implications for Plan Sponsors

ERISA expense accounts are an increasingly utilized tool to manage a plan sponsor's fiduciary duties with respect to revenue sharing payments paid to a recordkeeper. When implementing any type of revenue sharing arrangement, whether a BSA or an ERISA budget account, the plan fiduciary must understand the details of the arrangement and monitor it on a regular and periodic basis. ❖

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