Explaining the USI Settlement

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In late August 2012, the DOL announced that it reached a settlement with USI Advisors (a Goldman Sachs subsidiary) to pay $1.27 million to 13 defined benefit pension plan clients for alleged ERISA violations. The issue was USI's failure to "fully disclose" receipt of "12b-1" fees paid by mutual funds over a 7-year period and failure to use them for the benefit of the plans. The DOL announcement of the settlement noted that investment advisors acting as fiduciaries, such as USI, cannot use their fiduciary authority "to receive an additional fee or to receive compensation from third parties" for the advisor's account. While the USI case involved defined benefit plans, it has lessons for all plan advisors.

USI's View. For its part, USI contended that it had done nothing wrong because all its revenue had been disclosed and that it received the 12b-1 fees in lieu of any commission. In its view, the fee arrangement was simply an unusual form of ERISA account in which all of the indirect compensation credited to the account was used to offset fees owed to USI.

12b-1 Fees and Revenue Sharing. Revenue sharing payments, such as 12b-1 fees and sub-transfer agency fees, compensate service providers, such as USI, for activities (typically recordkeeping or accounting) on behalf of the mutual fund payor or the plan. Plan fiduciaries must evaluate what the provider does in relation to both this indirect compensation and any compensation that is paid directly by the plan sponsor or the plan.

Until recently, many plan sponsors knew nothing about the indirect compensation and, as a result, may have authorized direct compensation that, when added to the indirect compensation, was more than what a reasonable person would have believed the services to be worth. More knowledgeable plan sponsors may have selected mutual funds with more revenue sharing so that the costs of the plan would not be seen by the participants who were ultimately paying these charges by reduced returns on their plan investments. This is what happened in the recent *ABB* case where the plan sponsor incurred a $13.4 million judgment attributable solely to its lack of concern in monitoring such payments.

New Fee Disclosures Included in Settlement Terms. The fee disclosure regulations that went into effect in July are intended to eliminate the obfuscation caused by revenue sharing. Under these regulations, the service provider must disclose the services it will provide and how much money it will get for performing these services, whether in the form of direct or indirect compensation. Each of these elements was incorporated in the terms of the USI settlement along with the requirement to incorporate such terms in a written contract or letter of understanding, but only in those service arrangements where actuarial and investment advisory services are bundled together. Other than the monetary aspect of the settlement (which did not include a penalty), the USI settlement terms are no more burdensome than what the current regulations require.

ERISA Accounts. To understand the DOL's objection to the USI fee arrangement, it is helpful to return to the idea that it was similar to a so-called "ERISA account" (sometimes referred to as an "ERISA budget" or an "ERISA expense account"). Where such an account is used, some or all of the indirect compensation paid with respect to a plan is placed in a special account that may be used to compensate a plan service provider. In one version of this strategy, the account is part of the plan assets and is shown as such on the plan's Form 5500. If it is fully utilized as of year's end by payment of compensation to service providers, the plan allocates the remainder to participants.

In another version, the ERISA account is part of the assets of a financial institution, such as USI, and does not belong to the plan. The plan may, however, direct the financial institution to use the assets in a number of ways, as specified by agreement, including the compensation of providers. If the plan discontinues the services of the financial institution, the account is usually forfeited. In other words, the financial institution gets to keep the account, because it does not constitute plan assets.

Fixed Fee Requirement. It would appear that the second type of account had been used in the USI case and that the DOL took exception to the fact that there was no limit on the portion of the account that could be retained by USI. If USI had specified a dollar amount as its fee and agreed to contribute to its plan clients all revenue sharing credited to the ERISA account in excess of that fee, all would have been well. Without such a limit, however, USI had an incentive to invest plan assets in those mutual funds that paid the highest 12b-1 fees in order to reap the highest possible fees for itself.

The rules for ERISA accounts are not entirely clear, and it is rumored that the DOL has guidance in the works. This and the fact that the plan sponsors may have been willing accomplices probably contributed to USI avoiding a monetary penalty for what might have been treated as a prohibited transaction. Instead, the DOL news release announcing the settlement categorized USI's fee practices as an "alleged violation" of ERISA. One's view of the harshness of such a settlement depends on where you sit, however, and the return of over a million dollars in fees would be an unwelcome event for most plan advisors. The moral is that fiduciary advisors and their clients should agree on a level fee (a specific dollar amount or a percentage of plan assets) in advance of any compensation arrangement utilizing the type of ERISA account employed by USI. ❖

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