REVENUE SHARING IN 401(K) PLANS: EMPLOYERS AS MONITORS?

DANA M. MUIR*

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This article presents a discussion of the use of revenue sharing by mutual funds and 401(k) plan service providers. The author engages in a historical exploration of how revenue sharing has been used in 401(k) plans and highlights how regulators have taken an increased interest in ensuring disclosure of fund monies diverted for revenue sharing purposes. In addition, the article discusses how the current federal regulatory framework for employee benefits has not adapted to the increased use of 401(k) plans. The author challenges how ERISA places the burden of monitoring compensation to service providers on the employers who make the 401(k) plan available to their employees and instead, presents several alternative frameworks that would decrease employer responsibility and liability for investment selection.

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Employees have maligned the use of revenue sharing[1] in 401(k) plans[2] as a burden on investment returns and a hidden source of wealth for plan service providers.[3] A few commentators have been shrill in their

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*Arthur F. Thurnau Professor of Business Law, Stephen M. Ross School of Business at the University of Michigan. dmuir@umich.edu. 734.763.3091. I appreciate the research support provided by Michigan Ross. Thank you to the organizers of the 2013 symposium at the University of Connecticut School of Law, *The Challenge of Retirement in a Defined Contribution World,* which helped me sharpen my thinking on a variety of issues, including those I discuss in this Article. I have served as an expert witness in a 401(k) case that involved revenue sharing.

[1] For a discussion of the nuances of the definition of revenue sharing, *see infra* text accompanying notes 23–27.

[2] 401(k) plans are employer-sponsored benefit plans that permit employees to contribute a portion of their future earnings to the plan. EMPLOYEE BENEFITS LAW 6–15 (Jeffrey Lewis et al. eds., 3rd ed. 2012).

[3] *See, e.g.*, Healthcare Strategies, Inc. v. ING Life Ins. & Annuity Co., No. 3:11-CV-282, 2012 U.S. Dist. LEXIS 184544, at *3–4 (D. Conn. Sept. 27, 2012) (ruling on various motions in a case where plaintiffs alleged that revenue sharing in a 401(k) plan violated federal law); *see also* Matthew D. Hutcheson, *Uncovering and Understanding Hidden Fees in Qualified Retirement Plans,* 15 ELDER L.J. 323,

criticism of revenue sharing.[4] Service providers have responded that traditionally they did not have any obligation to report or limit the amount of revenue sharing they received and that revenue sharing has supported growth and innovation in 401(k) plans.[5] Policy groups have concluded that the use of revenue sharing in 401(k) plans is widespread and not necessarily pernicious.[6] Given the varying perspectives of the parties, none of that is surprising or particularly troubling.

What is troubling, however, is the extent to which responsibility for alleged misuse of or failure to monitor revenue sharing in 401(k) plans is laid at the feet of employers who voluntarily sponsor those plans. In my view, this assignment of responsibility for decision making and oversight is just one example of a larger issue – an antiquated regulatory model of employer responsibility in 401(k) plans.[7] To maximize the opportunity of employees to build lifelong financial security through the United States paradigm of voluntary plan sponsorship, it is imperative that the regulatory system properly allocate responsibility and liability. My goal in this Article is modest; I will evaluate the way in which the federal law that

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328 (2007) ("'Revenue sharing' is a euphemism for kickbacks from one financial services firm to another and is a common economic driver of conflicts of interest.").

[4] *See* Hutcheson, *supra* note 3, at 328 ("'Revenue sharing' is a euphemism for kickbacks from one financial service firm to another . . . ."); Cris de la Torre & Rutilio Martinez, *Mutual Fund Revenue Sharing: A Case of Pay to Play,* 4 J. PERS. FIN. 47, 48 (2005) ("'[R]evenue sharing' . . . looks very much like a 'pay to play' practice associated with the supermarkets and shelf space . . .").

[5] *See, e.g.*, Leimkuehler v. Am. United Life Ins. Co., 713 F.3d 905, 914 (7th Cir. 2013) (finding that plan administrator was not a fiduciary with respect to revenue sharing it received).

[6] ERISA ADVISORY COUNCIL, REPORT OF THE WORKING GROUP ON FIDUCIARY RESPONSIBILITIES AND REVENUE SHARING PRACTICES (2007), *available at* http://www.dol.gov/ebsa/publications/AC-1107b.html ("[R]evenue-sharing in a broad sense allows the market 'to develop efficiencies and innovations that have enhanced the quality of services of products available to [defined contribution] and 401(k) plans.'").

[7] *See* Dana M. Muir, *Choice Architecture and the Locus of Fiduciary Obligation in Defined Contribution Plans*, 99 IOWA L. REV. 1 (2013) (criticizing assignment of responsibility to employers for selection and oversight of plan investment options).

regulates benefit plans, the Employee Retirement Income Security Act (ERISA),[8] applies to the use of revenue sharing in 401(k) plans.

I begin this Article with a discussion of the history of revenue sharing in 401(k) plans and how that history relates to the use of revenue sharing outside plans. The discussion shows that revenue sharing has become an integral part of 401(k) plan history. In Part II, I assess the limited information that has been available on the prevalence of revenue sharing in 401(k) plans. Until the early-to-mid 2000s, little attention appears to have been paid to revenue sharing except by those who pay and receive it. That Part also considers innovations in 401(k) plans, which may have been supported by the use of revenue sharing.

In Part III, I briefly explain the extent to which federal employee benefits regulation applies to the use of revenue sharing in 401(k) plans. In contrast to federal disclosure requirements, the governing fiduciary framework has not adapted to the increased importance and complexity of 401(k) plans. ERISA's fiduciary standards do not impose any responsibility or liability regarding revenue sharing on the mutual funds that pay it or the plan service providers that receive it. Instead, employers bear the burden of assessing the practice. The potential liability of employers regarding revenue sharing is comprised of two primary responsibilities: employers must (1) ensure that compensation to plan service providers is reasonable and (2) act loyally and prudently when choosing and monitoring the investments that employees may make through the 401(k) plan. In Part IV, I raise the question of whether employers are the best-positioned actors among the constellation of plan-related actors to monitor revenue sharing. I end by briefly outlining alternative regulatory structures that would reallocate responsibility away from employers.

I. HISTORY OF REVENUE SHARING IN 401(K) PLANS

The development and expansion of 401(k) plans supported growth in the mutual fund industry and has been linked from the relatively early days of those plans with the use of revenue sharing. The addition of

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[8] Employee Retirement Income Security Act (ERISA) of 1974, Pub. L. No. 93–406, 88 Stat. 829 (codified as amended in scattered sections of 26 and 29 U.S.C.).

subsection (k)[9] to Section 401[10] of the Internal Revenue Code (Code) in 1978 first permitted what have come to be known as 401(k) plans. At that time, defined benefit (DB) plans, which typically provide guaranteed lifetime incomes, were the paradigmatic type of retirement plan in the United States.[11] The original purpose of the 1978 amendment was to clarify that employees could contribute to benefit plans through salary reductions, not to remake the U.S. system of private sector retirement plans.[12]

The number of 401(k) plans grew after the Internal Revenue Service (IRS) issued explanatory regulations in 1981.[13] As of 1996, 401(k) plan accounts held $1 trillion in assets. By the end of 2005, 401(k) plans had surpassed DB plans in terms of numbers of participants (employees and their beneficiaries who are entitled to plan benefits) and assets. 401(k) plans continue to be the most prevalent type of retirement plan sponsored by private sector employers. 401(k) plan assets grew from $2.4 trillion in 2005 to almost $3.8 trillion as of March 31, 2013.[14]

According to one report, in the early days of 401(k) plans, some employers were reluctant to handle plan administration services such as: (a) communications,; (b) acting as the liaison between participants, mutual

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[9] Revenue Act of 1978, Pub. L. No. 95-600, §135(a), 92 Stat. 2763, 2785 (Nov. 6, 1978).

[10] I.R.C. § 401(k) (2006).

[11] Other types of retirement plans were so insignificant at that time that they were not even included in the National Compensation Survey. *See* EMP. BENEFIT RESEARCH INST., EBRI DATABOOK ON EMPLOYEE BENEFITS Table 10.1(a) (2005), *available at* http://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2010.pdf.

[12] *See* EMP. BENEFIT RESEARCH INST., HISTORY OF 401(K) PLANS: AN UPDATE (2005), *available at* http://www.ebri.org/pdf/publications/facts/0205fact.a.pdf.

[13] Dana M. Muir, *The Dichotomy Between Investment Advice and Investment Education: Is No Advice Really the Best Advice?,* 23 BERKELEY J. EMP. & LAB. L. 1, 6 (2002).

[14] SARAH HOLDEN ET AL., 401(K) PLANS: A 25-YEAR RETROSPECTIVE 3 (2006), *available at* http://www.ici.org/pdf/per12-02.pdf; SARAH HOLDEN & DANIEL SCHRASS, DEFINED CONTRIBUTION PLAN PARTICIPANTS' ACTIVITIES, FIRST QUARTER 2013 2 (July 2013), *available at* http://www.ici.org/pdf/ppr_13_rec_survey_q1.pdf. Comparatively, in 2005, DB plans held $1.9 trillion in assets and $2.7 trillion as of March 31, 2013. Holden et al., *supra*; Robert Steyer, *ICI: Retirement Assets Total $20.8 Trillion in First Quarter 2013*, PENSIONS & INVESTMENTS, June 26, 2013, http://www.pionline.com/article/20130626/ONLINE/130629908/ici-us-retirement-assets-hit-record-208-trillion.

funds; and (c) trading. While there is no data on why employers decided not to handle these functions themselves, the administration of investment accounts is not among the core competencies of most employers. It makes sense that third parties could perform the functions more efficiently than if each employer had to develop and maintain its own staff and capabilities. Consulting firms apparently spotted the business opportunity and began to perform the necessary administrative plan functions. Perhaps to compete on the direct costs that were most visible to employers choosing among service providers, in the early 1990s, those service providers began to seek payments – revenue sharing -- from the mutual funds that were offered as investments in 401(k) plans.[15]

In theory, instead of making payments to consulting firms, the mutual funds themselves could have developed the expertise to provide administrative services to 401(k) plans. Eventually, as the industry and 401(k) plans grew, large fund families developed the capabilities needed to offer plan administrative services.[16] During the 1990s, however, it appears that at least some mutual funds concentrated on their investment expertise and chose not to deal directly with investors or employers that sponsored 401(k) plans. For sales to investors who were not 401(k) plan participants, mutual funds relied on brokers and personal investment advisers to handle the interactions with investors, including communications, customer service, and trading. The mutual funds compensated the brokers and investment advisers for those services by paying them a portion of the funds' revenue (an early form of revenue sharing).[17] The revenue sharing to the service providers that fulfilled parallel functions in 401(k) plans mirrored the practice used by the funds outside 401(k) plans.

Modern mutual funds pre-date 1940, when the Investment Company Act of 1940[18] was enacted to regulate the industry. In 1981,

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[15] McHenry Consulting Group, *Revenue Sharing in the 401(k) Marketplace: Whose Money Is It?*, 3 (2001), *available at* http://www.plansponsor.com/pdfs/White%20Papers/McHenry_Rev_Share_Report.pdf.

[16] *See, e.g.*, Tussey v. ABB, Inc., No. 2:06-CV-04305-NKL, 2012 U.S. Dist. LEXIS 45240, at *7 (W.D. Mo. Mar. 31, 2012) (discussing the various plan-related roles played by affiliates of Fidelity Investments).

[17] John Howat & Linda Reid, *Compensation Practices for Retail Sale of Mutual Funds: The Need for Transparency and Disclosure,* 12 FORDHAM J. CORP. & FIN. L. 685, 687-94 (2007).

[18] Investment Company Act of 1940, ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1-64 (2006)).

when the IRS issued the first 401(k) regulations, U.S. mutual funds held assets of just over $241 billion.[19] As 401(k) plans grew in assets and popularity, so did mutual funds. The fate of the two is linked because a significant percentage of the assets invested in mutual fund assets are typically held in retirement plan accounts. By the end of 2005, mutual funds held almost $8.1 trillion in assets, and that number grew to more than $13 trillion at the end of 2012.[20] At that time, $2.7 trillion of those assets were held in defined contribution plans.[21]

In 1980, the Securities and Exchange Commission (SEC) promulgated Rule 12b-1,[22] which formalized the ability of mutual funds to use fund assets to pay for marketing and distribution costs. Here, a brief detour into terminology is warranted. The securities industry and its commentators typically break payments made from mutual funds into more categories than is typical of the employee benefits industry and its commentators. For example, in an article focused on securities law, Professors Howat and Reid discussed a variety of "enhanced compensation arrangements"[23] used by mutual funds. They explained revenue sharing as "occur[ring] when a fund manager agrees to pay a brokerage firm cash compensation not otherwise disclosed in the prospectus fee table to promote the mutual fund to the broker's clients."[24] They separately define 12b–1 fees, which are paid by mutual funds out of fund assets rather than by the fund manager, as a separate category of fees.[25] As for other categories of enhanced compensation practices they discuss "directed brokerage," "soft dollar practices," and "differential cash compensation."[26] Often, the employee benefits community includes any payments made from mutual funds or their managers in its use of the term revenue sharing.[27] In

[19] INVESTMENT COMPANY INSTITUTE, *2013 Investment Company Fact Book* 142 (2013), *available at* http://www.ici.org/pdf/2013_factbook.pdf.

[20] *Id.*

[21] *Id.* at 132. The report does not break out 401(k) account holdings from the more inclusive category of defined contribution accounts. *Id.*

[22] *Bearing of Distribution Expenses by Mutual Funds,* Investment Company Act Release No. 11,414, 45 Fed. Reg. 73,898 (Nov. 7, 1980).

[23] Howat & Reid, *supra* note 17, at 687.

[24] *Id.* at 689–90.

[25] *See id.* at 694 (stating that the expense ratio of a fund typically includes an advisory fee, administrative fee and 12b-1 fees).

[26] *Id.* at 688–91.

[27] *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE (GAO), GAO-12-325, 401(K) PLANS: INCREASED EDUCATIONAL OUTREACH AND BROADER OVERSIGHT

employee benefits parlance, revenue sharing includes both its narrow securities law definition and other amounts paid by mutual funds, such as 12b-1 fees. Unless otherwise specifically noted, in this Article, I use the term "revenue sharing" in this broad sense, as defined by the employee benefits community.

The now well-known brokerage company, Charles Schwab Corporation (Schwab), is credited with using the concept of revenue sharing to establish a 401(k) plan paradigm that remains in widespread use today. In 1992, it first offered what it described as an "innovative service," which allowed investors to choose among multiple mutual funds from a variety of fund families rather than being limited to a single fund family and to do so without paying any direct fees to Schwab for administering their accounts.[28] As with other mutual fund practices, such as revenue sharing where mutual funds used parallel approaches for individual investors and 401(k) plans,[29] Schwab offered its new innovation to 401(k) plan sponsors as well as to individual investors. In the 401(k) offering, Schwab provided record keeping services, including a single statement for participants showing their investments in all funds. Schwab originally referred to this as a "no transaction fee" (NTF) program. Reportedly, "Schwab eliminated transactions costs, supporting the platform on revenue generated by fund distribution commissions and servicing fees."[30] In simple terms, Schwab's NTF model relied on revenue sharing to pay for all of the services that Schwab provided to 401(k) plans or to individual investors. As discussed below, the use of revenue sharing to offset plan costs continues to be in widespread use to this day.

MAY HELP REDUCE PLAN FEES 10 (2012), *available at* http://www.gao.gov/assets/600/590359.pdf (defining revenue sharing "in the 401(k) plan industry, [as] generally referr[ing] to indirect payments made from one service provider, such as the investment fund provider, to another service provider in connection with services provided to the plan, rather than payments made directly by the plan sponsor for plan services.").

[28] Charles Schwab, *Schwab's Mutual Fund OneSource® at 20: How a Single Idea Transformed the Way America Invests* at 4 (2012), *available at* http://www.aboutschwab.com/images/press/071612MFOSWhitePaper.pdf.

[29] *See supra* notes 15–17 and accompanying text.

[30] McHenry Consulting Group, *supra* note 15, at 3.

II. REVENUE SHARING IN 401(K) PLANS – SCOPE AND EFFECT

Little reliable historical data exists on the growth and amount of revenue sharing that has been paid within 401(k) plans. However, as the first subsection below discusses, the available evidence indicates that the dollar volume of revenue sharing is substantial and the practice is widely used. To provide some context for the way revenue sharing may redound to the benefit of 401(k) plan participants, the following subsection discusses the complexity of plan administration and services.

A. SCOPE OF REVENUE SHARING IN 401(K) PLANS

Plans were not required to report revenue sharing until 2009, when the Department of Labor (DOL) began requiring reporting of those payments as part of large plans' annual reporting.[31] To this day, securities law requires reporting of 12b-1 fees, but not those fees paid by fund managers that are known as revenue sharing in the securities law community.[32] As one data point in 2006, 12b-1 fees paid by all mutual funds, not just those held in 401(k) accounts and excluding revenue sharing as used in the securities context, totaled $11.8 billion.[33]

It appears that plan fees and employer responsibilities for understanding those fees started to become of interest to regulators in the late 1990s. The DOL commissioned a study of 401(k) fees which culminated in a report entitled "Study of 401(k) Plan Fees and Expenses."[34] That report explicitly discussed 12b-1 and other types of fees[35] but did not use the term "revenue sharing." However, it recognizes the general concept that "[i]n the case of mutual fund expense ratios or where the investment management fees are otherwise incorporated in net asset

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[31] *See* Michele A. Rivas, *Fee Disclosures by Service Providers to Benefit Plans: How to Protect Your Clients,* 34 MI. TAX L. 11, 12-13 (2008). Plans do not always need to report revenue sharing separately from other types of compensation paid to plan service providers. *Id.* at 13.

[32] *See* Howat & Reid, *supra* note 17, at 689–96.

[33] John P. Freeman, *The Mutual Fund Distribution Expense Mess,* 32 IOWA J. CORP. L. 739, 744 (2007).

[34] PENSION & WELFARE BENEFITS ADMIN., ECONOMIC SYSTEMS, INC., STUDY OF 401(K) PLAN FEES AND EXPENSES (1998), *available at* http://www.dol.gov/ebsa/pdf/401kRept.pdf.

[35] *See id.* at 3.3.5.

valuation computations, participants pay all of the fees."[36] In addition to the study, in 1997, the DOL held hearings on the transparency of fees in 401(k) plans. The extent to which employers and participants would benefit from increased transparency was somewhat controversial.[37]

In spite of the amount of revenue sharing changing hands and its role in 401(k) plan innovation, the first report I have found that explicitly refers to revenue sharing as such in the context of 401(k) plans was issued by the McHenry Consulting Group in 2001.[38] That report, titled "Revenue-Sharing in the 401(k) Marketplace," explained that U.S. securities laws permit mutual fund companies to share their revenues with service providers to 401(k) plans. According to the report, "Almost every investment and administration service provider engages in this activity to some degree. It is virtually impossible to compete in the 401(k) marketplace without subsidies to help offset service costs, as provided by asset-based revenues."[39] It also provides some general information about the costs of plan services and the kinds of services that affect costs.[40]

A policy advisory group to the DOL, known as the ERISA Advisory Council,[41] of which I was a member at the time, studied revenue sharing in 2004. In my experience, each year, the ERISA Advisory Council members choose approximately three issues to consider. Working groups are constituted to study those issues. ERISA Advisory Council members then volunteer to serve on any or all of the working groups, according to interest and expertise.

The 2004 working group on plan fees and reporting on Form 5500 (Fees and Reporting Working Group) heard testimony over multiple days from a number of industry participants about plan fees, and some of those

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[36] *Id.* at 5.3.2.

[37] *See id.* at 5.3.3 (reporting that the disclosure to sponsors and participants of fees and expenses imposed on 401(k) plans is often not complete and that this lack of information may affect the costs to the plans).

[38] McHenry Consulting Group, *supra* note 15.

[39] *Id.* at 4.

[40] *Id.* at 5–6.

[41] ERISA Advisory Councils are comprised of fifteen member groups of citizens appointed for staggered three-year terms by the Secretary of Labor. Pub. L. 93-406, tit. I, § 512, 88 Stat. 895 (1974) (codified at 29 U.S.C. § 1142 (2006)). I was a member of the ERISA Advisory Council from 2002–2004, and was a member of both the working group that studied plan fees and reporting and the one that studied fee and related disclosures to participants.

witnesses discussed revenue sharing.[42] As is typical, the working group's final report includes summaries of the testimony of each witness and the group's overall findings based on the testimony. The report confirms that the data available to the employee benefit plans community on revenue sharing were limited. A number of the witnesses discussed the lack of transparency of plan fees and revenue-sharing arrangements.[43] None of the witnesses that I remember advanced a legal theory under which service providers had any obligation to disclose revenue sharing unless asked by an employer. Nor were revenue-sharing disclosures required as part of plans' annual reporting to the DOL.

In spite of the lack of specific data, the working group's conclusions reflect the testimony that 401(k) plan service providers often relied on revenue sharing to compensate them in full or part for the services they provided to the plan.[44] In its findings, the Fees and Reporting Working Group wrote: "[t]he testimony established that explicit charges in many plans have been substantially reduced or nearly completely eliminated and the majority of costs associated with administering many retirement plans are now embedded in the form of asset-based fees and borne by the plan participants."[45] The report recommended that the DOL study regarding the reporting of plan fees, including the use of revenue sharing, should be required.[46]

At least two other direct or indirect references to revenue sharing and 401(k) plans date to 2004. A second working group of the 2004 ERISA Advisory Council focused on the somewhat different issue of how fee disclosures related to participant investment elections.[47] That group's final report did not directly discuss revenue sharing, except to the extent that specific witnesses used the term and it became part of the summaries

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[42] *See* ADVISORY COUNCIL ON EMP. WELFARE & PENSION BENEFIT PLANS, REPORT OF THE WORKING GROUP ON PLAN FEES AND REPORTING ON FORM 5500 (2004), *available at* http://www.dol.gov/ebsa /publications/AC_111804_report.html.

[43] *See, e.g.*, *id.* at 10.

[44] *Id.* at 2.

[45] *Id.* at 5.

[46] *Id.* at 3.

[47] *See* ADVISORY COUNCIL ON EMP. WELFARE & PENSION BENEFITS PLANS, REPORT OF THE WORKING GROUP ON FEE AND RELATED DISCLOSURES TO PARTICIPANTS (2004), *available at* http://www.dol.gov/ebsa/publications/AC_ 111704_report.html.

of the individual testimony.[48] In addition, the *New York Times* quoted an employee of a prominent benefits consulting firm as stating that "90% of 401(k) plans engage in revenue sharing."[49]

Interest in and discussion about the prevalence of revenue sharing in 401(k) plans has continued. In 2007, another working group of the ERISA Advisory Council studied fiduciary responsibilities and revenue-sharing practices. In introducing its findings on revenue sharing, the report states, "[t]he Working Group recognized that there was a considerable amount of consensus with respect to the concept of revenue sharing, how it can benefit plan sponsors and their participants."[50] The first of its four consensus thoughts was that "[r]evenue sharing is an acceptable practice."[51] The prevalence of revenue sharing is implicit in those statements and throughout the report. The report also reflects a belief that revenue sharing pays for plan services that would have to be paid for in some other way in the absence of revenue sharing. "[T]he Working Group recognized that revenue sharing was a common and considerable practice used to offset plan expenses with respect to [defined contribution] plans."[52]

Today, revenue sharing continues to be widely used in 401(k) plans and to attract the attention of commentators and policy makers. In a 2011 report on fees in the 401(k) plan marketplace, Deloitte reported survey results showing that 55 percent of the responding plan sponsors reported that "all of the record-keeping and administrative fees are paid through investment revenue."[53] In 2012, the Government Accountability Office (GAO) released the results of its study of 401(k) plan fees, which is discussed in more detail below.[54] The DOL has also imposed a variety of mandatory reporting requirements regarding plan fees and the use of revenue sharing.[55]

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[48] *Id.* at 13, 18.

[49] Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries,* 158 U. PA. L. REV. 1961, 2004 n.269 (2010) (quoting Lynn O'Shaughnessy, *A 401(k) Picks a Mutual Fund. Who Gets a Perk?,* N.Y. TIMES, Feb. 15, 2004, at BU5).

[50] ERISA Advisory Council, *supra* note 6, at 3.

[51] *Id.*

[52] *Id.* at 1-2.

[53] DELOITTE ET AL., ANNUAL 401(K) BENCHMARKING SURVEY 24 (2011), *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_consulting_Deloitte%20401k%20Survey_2011%20edition_12082011.pdf.

[54] GAO, *supra* note 27; *see also infra* text accompanying notes 114-17.

[55] *See infra* text accompanying notes Part III.A.

B. EFFECT OF REVENUE SHARING IN 401(K) PLANS

Since Schwab created the NTF model in 1992, 401(k) plans have added services to participants, increased the average number of investment options they offer participants, and complied with increasing regulatory obligations. Plans now face far more extensive regulatory requirements than at the time 401(k) plans began.[56]

The costs of these elaborate and extensive services may be shared between employers and employees, but employees usually pay the largest share. One survey shows that 83 percent of all fees associated with 401(k) plans are paid by plan participants. Most of those payments are made through revenue sharing. The survey also notes that some of the revenue sharing may pay for plan administration, including recordkeeping.[57]

The main concern that seems to be expressed about the effect of revenue sharing on 401(k) plan participants is the lack of transparency associated with revenue sharing. According to one commentator, Matthew Hutcheson,[58] "[r]evenue sharing is the 'big secret' of the retirement

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[56] *See, e.g.*, DEP'T OF LABOR, FINAL REGULATION RELATING TO SERVICE PROVIDER DISCLOSURES UNDER SECTION 408 (B)(2): FACT SHEET (2012), *available at* http://www.dol.gov/ebsa/newsroom/fs408b2finalreg.html (explaining the obligation of service providers to disclose compensation to plan fiduciaries, which implies the obligation of plan fiduciaries to evaluate those disclosures); DEP'T OF LABOR, FINAL RULE TO IMPROVE TRANSPARENCY OF FEES AND EXPENSES TO WORKERS IN 401(K)-TYPE RETIREMENT PLANS: FACT SHEET (2012), *available at* http://www.dol.gov/ebsa/newsroom/fsparticipantfeerule.html (explaining final regulations requiring plans to disclose plan fees to participants); DEP'T OF LABOR, REGULATION RELATING TO QUALIFIED DEFAULT INVESTMENT ALTERNATIVES IN PARTICIPANT-DIRECTED INDIVIDUAL ACCOUNT PLANS (2008), *available at* http://www.dol.gov/ebsa/newsroom/fsQDIA.html (explaining the effect of and requirements for a 401(k) plan offering a "qualified default investment alternative.").

[57] DELOITTE, INSIDE THE STRUCTURE OF DEFINED CONTRIBUTION/401(K) PLAN FEES: A STUDY ASSESSING THE MECHANICS OF THE 'ALL-IN' FEE 5 (2011), *available at* https://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents /us_consulting_StructureofDefineContribution_112411.pdf.

[58] In 2013, Mr. Hutcheson was sentenced to prison after being convicted of wire fraud in connection with his service as a retirement plan fiduciary. *See* U.S. DEP'T OF JUSTICE, *Eagle Man Sentenced to Over 17 Years in Prison for Theft from Retirement Plans* (July 31, 2013), http://www.justice.gov/usao/id/news/2013/jul/hutcheson07312013.html.

industry."[59] Some witnesses to the ERISA Advisory Council's 2004 Fees and Reporting Working Group expressed the view that neither participants nor plan sponsors had a good understanding of revenue sharing.[60] Mr. Hutcheson feared that revenue sharing "impair[s] the retirement income security of participants,"[61] and could result in fiduciary liability for plan sponsors who fail to consider these costs when making decisions regarding plan service providers.[62]

However, to the extent that sponsors with that plan face fiduciary liability because of the lack of transparency in revenue sharing, one response – and the one I advocate later in this Article – is that the system has it wrong when it allocates fiduciary responsibility for revenue sharing-related decision making to plan sponsors.[63] If, as the 2007 ERISA Working Group found, revenue sharing has encouraged the development of important services to participants and enhanced the popularity of 401(k) plans, then it would seem to have accomplished the opposite of impairing retirement security.

It is important to recognize that the array of functions provided by 401(k) plan service providers is very broad. Those functions include account statements, educational programs and materials, investment transactions, call centers, web sites, etc., that provide information and receive transaction orders, process plan loans, distributions, roll-overs, contributions, and court orders to divide 401(k) plan accounts upon a participant's divorce, etc. Some of these services, such as account statements, are required by law.[64] Others, such as call centers and websites, are not required but provide participants with enhanced access to information about their accounts and efficient methods of implementing investment decisions. Service providers may perform a variety of other services, such as preparing annual reports the plan must file with the DOL[65]

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[59] Hutcheson, *supra* note 3, at 328.

[60] ERISA Advisory Council, *supra* note 42, at 9-10, 12.

[61] Hutcheson, *supra* note 3, at 328.

[62] *Id.*

[63] *See infra* text accompanying notes 146-48.

[64] *See, e.g.*, ERISA § 105(a)(1)(A)(i), 29 U.S.C. § 1025(a)(1)(A)(i) (2006) (requiring plans that permit participants to choose their investments to provide a benefits statement at least quarterly).

[65] *See, e.g.*, ERISA § 103, 29 U.S.C. § 1023 (2006) (requiring plans to file annual reports). Filing Form 5500 with the DOL fulfills this reporting requirement. *See* Fisch, *supra* note 49, at 1986 (briefly discussing Form 5500 filing obligations).

and holding account assets in trust[66] to enable plans to comply with legal requirements. Finally, 401(k) service providers may undertake functions such as investment recordkeeping and serving as the interface between participants and investment providers such as mutual funds. One commentator identified fourteen different entities or people that may receive payments from 401(k) plan assets for services provided to those plans.[67]

The complexity of plan recordkeeping, participant communications, and similar services may also be affected by the investment choices offered to plan participants. The investment options from which participants may choose, often referred to as the investment menu, have increased from an average of six in 1995 to fourteen in 2005.[68] When new financial products are developed, that can raise the question of whether those products are suitable for 401(k) plans.[69]

The services provided by 401(k) plans redound to the benefit of plan participants and enable them to build wealth in those plans. Providers of those 401(k) plan services must be compensated in some way for their services. As explained above, the norm has become to pay for some or all of the costs through revenue sharing. One prominent scholar explained it this way: "the employees bear the costs of running the plan but pay those

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[66] ERISA § 403(a), 29 U.S.C. §1103 (2006).

[67] Hutcheson, *supra* note 3, at 344-47; *see also* GAO, *supra* note 27, at 7-9 (discussing the variety of plan service providers and how services may be combined, which is referred to in the industry as bundled services).

[68] Holden et al., *supra* note 14, at 17. It is useful to note, however, that work by behavioral economists indicates that it is better for retirement participants to have only a small number of investment options because too large a set of options may discourage participants from participating in the plan. Sheena S. Iyengar et al., *How Much Choice Is Too Much?: Contributions to 401(k) Retirement Plans*, in PENSION DESIGN AND STRUCTURE: NEW LESSONS FROM BEHAVIORAL FINANCE, 83-95 (Olivia S. Mitchell & Stephen P. Utkus eds., 2004). One important strategy that has been successful in increasing plan participation is to automatically enroll participants in plans while also providing them the opportunity to actively opt out. *See* Dana M. Muir, *Default Settings in Defined Contribution Plans: A Comparative Approach to Fiduciary Obligation and the Role of Markets,* 28 A.B.A. J. LAB. & EMP. L. 59, 60-61 (2012) (outlining the use of defaults in 401(k) plans).

[69] *See, e.g.*, William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds,* 33 DEL. J. CORP. L. 69, 74 (2008) (discussing the possibility that 401(k) plan menus might include exchange-traded funds (ETFs)).

costs indirectly through the fees charged to them by the participating mutual funds."[70]

Arguably, revenue sharing has had a positive effect on the popularity of 401(k) plans and on the breadth of services the plans provide to participants. This was the view of the 2007 ERISA Working Group, which wrote: "revenue-sharing in a broad sense allows the market 'to develop efficiencies and innovations that have enhanced the quality of services of products available to [defined contribution] and 401(k) plans.'"[71] The report also states: "[t]he witnesses generally testified, and the Working Group recognizes that revenue sharing supports a wide variety of distribution and shareholder servicing activities, including administrative record keeping and sub-transfer agent services that were traditionally viewed as investment fund responsibilities."[72]

III. THE ROLE OF EMPLOYERS IN MONITORING REVENUE SHARING

Federal pension regulation applies a two-prong approach to revenue-sharing. One component relies on disclosure and the other on substantive fiduciary obligation. This Part addresses each of those in turn. The analysis shows that employers bear the primary fiduciary burden vis-à-vis the use of revenue sharing in 401(k) plans. It further reveals that employers' fiduciary obligation with respect to revenue sharing is comprised of two main components: (i) the obligation to ensure that compensation to plan service providers is reasonable; and (ii) the need to act loyally and prudently when choosing and monitoring products for the plan's investment menu.

A. DISCLOSURE OF REVENUE SHARING IN 401(K) PLANS

During the past five years, the DOL has overhauled the reporting of the compensation received by employee benefit plan service providers, including their receipt of revenue-sharing. The first disclosure obligation became effective in 2009 when large plans[73] were required to identify in

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[70] Fisch, *supra* note 49, at 2004-05.

[71] ERISA ADVISORY COUNCIL, *supra* note 6.

[72] *Id.*

[73] Large plans typically are those with at least one hundred participants. As of 2005, approximately 86 percent of those participating in a 401(k) plan were in a

the annual reports they file with the DOL all service providers who directly or indirectly receive more than $5,000 compensation during the plan year covered by the reporting.[74] Although this increased the transparency of service provider compensation, gaps remained. The definition of compensation was broad enough to include revenue sharing.[75] However, in certain situations, revenue sharing can be included with other types of compensation rather than being separately reported.[76] Second, nothing in this annual reporting requirement required service providers to disclose their compensation to plan sponsors.[77] When plan sponsors did not have compensation information from the service providers, the plan sponsors could meet their disclosure obligation by identifying service providers and noting the lack of information.[78]

The next prong of the DOL's effort to increase the transparency of 401(k) fees became effective in 2012 when it issued final regulations requiring plan service providers that receive at least $1,000 annually in plan-related compensation to disclose their total compensation to plan fiduciaries.[79] In turn, the plan now must disclose administrative fees and expenses to plan participants.[80] Guidance issued by the DOL makes clear that both sets of disclosure requirements include revenue sharing.[81]

In addition to providing information to plan sponsors and participants, disclosures of plan administrative fees and expenses may be of

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large plan. *See* Debra A. Davis, *How Much is Enough? Giving Fiduciaries and Participants Adequate Information About Plan Expenses,* 41 J. MARSHALL L. REV. 1005, 1022 (2008).

[74] *Id.* at 1023.

[75] *See* DEP'T OF LABOR, *Frequently Asked Questions: The 2009 Form 5500 Schedule C, Q14*, http://www.dol.gov/ebsa/faqs/faq_scheduleC .html.

[76] *See id.*

[77] Davis, *supra* note 73, at 1023.

[78] *See id.*

[79] DEP'T OF LABOR, FINAL REGULATION RELATING TO SERVICE PROVIDER DISCLOSURES UNDER SECTION 408(B)(2): FACT SHEET 2 (2012), *available at* http://www.dol.gov/ebsa/newsroom/fs408b2finalreg.html.

[80] DEP'T OF LABOR, FINAL RULE TO IMPROVE TRANSPARENCY OF THE FEES AND EXPENSES TO WORKERS IN 401(K)-TYPE RETIREMENT PLANS: FACT SHEET 2 (2012), *available at* http://www.dol.gov/ebsa/newsroom/fsparticipantfeerule. html.

[81] *See* DEP'T OF LABOR , FEE DISCLOSURE GUIDANCE, FIELD ASSISTANCE BULLETIN 2012 – 02 (2012), *available at* http://www.dol.gov/ebsa/regs/ fab2012-2.html.

value to other interested parties. The tax-advantaged nature of 401(k) plans means that a variety of government agencies, including the Internal Revenue Service, may have an interest in the information. Securities analysts, independent researchers, and competitors of both plan sponsors and plan service providers may also find the information useful.

It is too early to tell whether the benefits of increased disclosure outweigh its costs. The reporting is complex[82] and commentators question the extent to which it is understood by either employers or employees.[83] As described below, plan service providers have an interest in making it difficult for employers to compare fees across plan providers.[84] The GAO's 2012 report discusses the extent to which employers have been comparing fees and, even after 2009, remain confused about plan fees and the role that revenue sharing plays in compensating plan service providers.[85]

B. FIDUCIARY RESPONSIBILITY AND REVENUE SHARING IN 401(K) PLANS

In addition to the relatively recent disclosure obligations just discussed, ERISA's fiduciary standards apply to revenue-sharing. This subsection explains ERISA's basic fiduciary requirements and how those requirements apply to the various parties involved in the use of revenue-sharing in 401(k) plans. It then explains the extent to which employers bear the primary fiduciary obligation in authorizing and monitoring the use of revenue-sharing in those plans.

When functioning as an ERISA fiduciary, individuals and entities must act loyally[86] and in accordance with a standard of care defined as that of a prudent person familiar with the benefit plan matters at issue.[87] To

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[82] *See, e.g.*, Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure, 77 C.F.R. § 5632 (containing a preamble in excess of 18 pages before the regulatory impact analysis).

[83] *See* Mark Mensack, *The Moral Hazard of Too Big to Jail,* J. COMP. & BENEFITS 42, 45 (2013) (discussing the frustration of some plan sponsors in trying to evaluate the feed disclosures).

[84] *See infra* text accompanying notes 118-20.

[85] GAO, *supra* note 27, at 24-28.

[86] ERISA § 404(a)(1)(A)(i), 29 U.S.C. § 1104(a)(1)(A)(i) (2006) ("solely in the interest of the participants and beneficiaries and . . . for the exclusive purpose of . . . providing benefits to participants and their beneficiaries.").

[87] *See* ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (2006); *see also* 29 C.F.R. § 2550.404a-1 (1997) (explaining the application of the prudence standard

supplement these trust law-based, general fiduciary standards, ERISA contains what are known as prohibited transactions provisions. One set of those provisions bars transactions between a plan and certain specified parties that have relationships with plans, including plan service providers, unless an exemption applies.[88]

ERISA utilizes a functional definition of fiduciary, which means that any person or entity that engages in actions involving discretionary plan administration, asset or plan management, or investment advice acts as a fiduciary.[89] This broad definition could lead a reasonable person to think that the mutual funds that pay revenue sharing, the service providers that administer plans and receive revenue sharing from account assets, and the employers who sponsor plans all act as ERISA fiduciaries. ERISA has a way, however, of confounding the expectations of reasonable people.

ERISA's fiduciary definition explicitly excludes from its scope the mutual funds that pay revenue sharing. Although the functional definition of fiduciary includes persons or entities that engage in discretionary asset management, the definition clarifies that investments of plan assets in mutual funds do not cause the mutual fund or its advisor to become an ERISA fiduciary.[90] It appears that Congress' rationale for the exclusion when it enacted ERISA, which was well before the existence of 401(k) plans, was that existing federal regulation of mutual funds was sufficient.[91]

Plan service providers, including those that receive revenue-sharing, typically avoid ERISA fiduciary status in one of two ways. First, they may not exercise the discretion that is required by the statute for fiduciary status. For example, entities that provide recordkeeping and similar services may successfully argue that they merely administer the

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to investment duties). ERISA's other fiduciary standards require benefit plan fiduciaries to minimize the risk of large losses by diversifying plan investments, ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (2006), and to act in accordance with plan documents, ERISA § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D) (2006).

[88] ERISA § 406(a)(1), 29 U.S.C. § 1106(a)(1) (2006).

[89] ERISA § 3(21)(a)(ii), 29 U.S.C. § 1002(21)(a)(ii) (2006).

[90] *See* ERISA § 3(21)(b), 29 U.S.C. § 1002(21)(b) (2006).

[91] *See* U.S. Dep't of Labor Adv. Op. 2009-04A (Dec. 4. 2009) (stating that "Congress concluded that it did not need to apply ERISA's fiduciary rules to the operation of mutual funds in addition to the Investment Company Act's regulatory scheme.").

terms of the plan and that does not constitute the fiduciary exercise of discretion.[92]

Second, some providers of investment advice to plans and participants may rely on an early DOL regulation that narrowly defined the provision of fiduciary investment advice. Under that regulation, issued in 1975 when DB plans were typical, an investment adviser is not a fiduciary when giving advice regarding benefit plan assets or an Individual Retirement Account (IRA) unless the adviser (1) advises on securities valuation or makes recommendations on the purchase or sale of securities, (2) on a regular basis, (3) according to a mutual agreement with the plan or a plan fiduciary, (4) that provides the advice will serve as the primary basis for decisions on investments, and (5) the advice is individualized to the plan's needs.[93] For example, entities that provide advice to employers on the selection of plan investments can avoid fiduciary status by providing the advice on a one time, rather than ongoing, basis.

The DOL recognizes that this narrow definition of fiduciary investment advice no longer has currency in the 401(k) plan environment. In 2010, the agency proposed regulations that would have dramatically increased the scope of financial advisory activities that result in a provider becoming a fiduciary when giving investment advice regarding benefit plan or IRA assets. The proposed regulatory definition tracked the general statutory definition and specifically stated that investment advice or recommendations given to a plan participant or beneficiary or to an investor regarding an IRA are a fiduciary act.[94] After widespread objection from the financial services sector, the DOL withdrew the proposed regulations.[95] Current indications are that the agency plans to revise and re-propose the regulations.[96]

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[92] *See e.g.*, Hecker v. Deere, 556 F.3d 575, 584 (7th Cir. 2009) (holding that the plan's service provider was not a fiduciary because it did not exercise discretion in plan administration or with respect to plan management); *cf.* Tussey v. ABB, Inc., No. 2:06-CV-04305-NKL, 2012 U.S. Dist. LEXIS 45240, at *100-01 (W.D. Mo. Mar. 31, 2012).

[93] Definition of the Term 'Fiduciary', 75 Fed. Reg. 65,263, 65,265 (proposed Oct. 22, 2010).

[94] *Id.* at 65,277.

[95] *Labor Department's EBSA to repropose rule on definition of a fiduciary,* U.S. DEP'T OF LABOR (Sept. 19, 2011), http://www.dol.gov/opa/media/press/ebsa/EBSA20111382.htm.

[96] U.S. Dep't of Labor, *Conflict of Interest Rule – Investment Advice,* FEDERAL REGISTER (2013), *available at* http://www.federalregister.gov/regulations/1210-

ERISA's exclusion of mutual funds from fiduciary status and de facto exclusion of nearly any service provider that wants to be excluded leaves employers holding the fiduciary bag for 401(k) plans. Jurisprudence and DOL authority make clear that ERISA's fiduciary definition encompasses certain acts of employers that sponsor a benefit plan, including the selection and monitoring of plan investments.[97] Employers may form a committee of employees to select and monitor plan investments or otherwise delegate those functions. In such an instance the employer remains a fiduciary for the appointment and monitoring of its agents and the agents are ERISA fiduciaries for the discretionary functions delegated to them.[98]

In September 2006, employees began alleging that fiduciary violations by employers resulted in inappropriately high 401(k) plan fees that in turn negatively affected the employees' account balances.[99] A complete analysis of the litigation involving plan fees is beyond the scope of this Article. It is useful, though, to consider one of the more prominent cases in order to categorize the types of responsibility employers face with respect to the use of revenue sharing in their 401(k) plans.

AB32/conflict-of-interest-rule-investment-advice (targeting October 2013 for reproposal).

[97] *See, e.g.*, Quan v. Computer Sci. Corp., 623 F.3d 870, 880-81 (9th Cir. 2010) (finding that employer-fiduciary's choice of investments was entitled to deference); Final Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans, 57 Fed. Reg. 46,906, 46,924 n.27 (Oct. 16, 1991) ("Thus . . . the plan fiduciary has a fiduciary obligation to prudently select such [investment options], as well as a residual fiduciary obligation to periodically evaluate the performance of such [investment options]."); *see also* 29 C.F.R. § 2550.404c-5(b)(2) (2012) ("Nothing in this [regulation] shall relieve a fiduciary from his or her duties under . . . ERISA to prudently select and monitor any qualified default investment alternative under the plan or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses."). *But see Hecker*, 556 F.3d at 586 (leaving open the issue of "whether [the plan sponsor's] decision to restrict the direct investment choices in its Plans . . . is even a decision within [the plan sponsor's] fiduciary responsibilities."), *order denying rehearing en banc,* 569 F.3d 708 (7th Cir. 2009).

[98] *See* Mark Casciari & Ian Morrison, *Should the Securities Exchange Act be the Sole Federal Remedy for an ERISA Fiduciary Misrepresentation of the Value of Public Employer Stock?,* 39 J. MARSHALL L. REV. 637, 643 (2006).

[99] *See* Chris Thixton, *A 401(k) Fee Lawsuit First*, PENSION CONSULTANTS INC. (Nov. 17, 2009), http://pension-consultants.com/2009/11/fee-lawsuit/.

In *Tussey v. ABB, Inc.*, 401(k) plan participants alleged, among other things, that their employer, ABB, Inc. (ABB), violated its fiduciary duties when making decisions on matters that involved revenue sharing.[100] First, ABB allegedly permitted Fidelity Trust, the 401(k) plan's recordkeeper, to receive such extensive revenue sharing payments that Fidelity Trust's compensation became excessive.[101] The excessive compensation allegedly subsidized work on non-401(k) plans that Fidelity Trust did for ABB. ABB failed to convince the court that it appropriately monitored the fees Fidelity Trust received.[102] According to the court, ABB was primarily concerned with minimizing its own costs rather than with ensuring the plan participants did not overpay Fidelity Trust.[103]

Second, the participants argued that ABB had violated its fiduciary obligations when it deleted one mutual fund offering and selected or kept other funds as part of the plan's investment menu.[104] The court determined that ABB inappropriately considered the "effect of the fund selected on recordkeeping fees, and what changes to the fee structure were in [ABB's] best interest" when replacing one fund with another.[105] ABB also decided to offer some share classes in the plan that charged higher fees to participants, and thus paid more in revenue sharing, than paid by other lower-fee share classes of the same funds that were available to the plan.[106] The court held the ABB fiduciaries jointly and severally liable for $34.2 million as a result of these fiduciary breaches.[107]

The *Tussey* decision illustrates that employers have two primary responsibilities when considering the use and scope of revenue sharing. First, the duties of loyalty and care require employers to ensure that any compensation paid by the plan, directly or indirectly, to its service providers is reasonable. Second, employers must act loyally and prudently when choosing and designating the investments offered to employees.

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[100] Tussey v. ABB, Inc., No. 2:06-CV-04305-NKL, 2012 U.S. Dist. LEXIS 45240, at *100-01 (Mar. 31, 2012).

[101] *See id.* at *28.

[102] *Id.* at *29.

[103] *Id.* at *31.

[104] *See id.* at *47-48.

[105] *Id.* at *57.

[106] *See id.* at *79.

[107] *Id.* at *116. The court awarded the plaintiffs an additional $1.7 million due to ABB's failure to monitor the way a Fidelity entity administered float income. *Id.*

In sum, ERISA's fiduciary framework, which was developed during an era of DB plan dominance, imposes significant responsibility on employers who sponsor 401(k) plans. Among those responsibilities is an obligation to select both plan service providers and the investments offered in the plan in accordance with fiduciary standards of loyalty and prudence. In contrast, ERISA generally does not impose fiduciary duties on either plan service providers or the providers of mutual funds offered as plan investments. Revenue sharing, which is frequently used to pay some or all of the costs of 401(k) plan administration, illustrates the challenges and burdens this regulatory approach poses for employers.

IV. EMPLOYERS AND 401(K) FIDUCIARY DUTIES

In this Part, I briefly explain the way employers' roles have changed as a result of the transition from a DB pension system to one that primarily relies on DC plans such as 401(k) plans. The basic alignment of interests that supported the choice of an employer-centric fiduciary framework for DB plan investments no longer exists. Furthermore, employers do not inherently have the expertise to select and monitor financial products targeted to individual investors or the way in which the product providers interact with other actors in the financial and 401(k) systems. Contributing to the task for employers are information asymmetries between employers and providers of 401(k) services and investment products. The Part concludes with a brief discussion of alternative regulatory approaches.

A. EMPLOYER INTERESTS AND EXPERTISE IN THE 401(K) PLAN SYSTEM

The role employers play in the retirement plans that they voluntarily sponsor has shifted significantly since ERISA's fiduciary provisions were enacted in 1974. ERISA requires employers to fund DB plans they sponsor to whatever degree necessary to enable the plans to pay promised benefits.[108] That means that employers with DB plans have a direct interest in plan investments and in the fees charged to the plans.

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[108] *See* Dana M. Muir, *Counting the Cash: Disclosure and Cash Balance Plans,* 37 J. MARSHALL L. REV. 849, 869 (2004) ("[E]mployers retain the obligation to fully fund a DB plan should investment returns not meet expectations . . .").

Positive investment returns reduce an employer's funding obligation, and every dollar of cost the plan pays in fees is a dollar that the employer must contribute to the plan. In addition, employers have full control over DB plan investment decision-making. The alignment of the employer's interests with the plan beneficiaries' interests favors treating the employers as plan fiduciaries.

In the 401(k) paradigm, employers' interests are less closely aligned with the retirement plan policy goal of maximizing employee opportunity to achieve lifelong financial security. Most 401(k) plans delegate to employees the decision on how to invest their account assets.[109] As a result, employers no longer control how plan assets are invested. Nor do employers have any direct interest in the investment returns. The investment vehicles used in 401(k) plans may be significantly different from those in DB plans. 401(k) investments must be suitable for the varied needs of participants, which depend on demographic and risk factors as well as plan scale. Since the plan service provider fees are typically paid either directly or indirectly by the participants, employers may be largely indifferent to the amount of those fees or the way in which they are charged to participants.

The change in the alignment of interests is not the only factor that favors reallocation of the fiduciary obligations in 401(k) plans. Employers, especially small ones, may not have the expertise to evaluate the financial products offered on their 401(k) plan menu. There is nothing in the business model of non-financial sector employers to lead a reasonable observer to believe that employers have the professional proficiency in financial planning necessary to decide on the appropriate set of investment choices to be offered to employees. Nor are employers necessarily knowledgeable about the increasing complexities of financial products and how those products operate within the larger 401(k) system that encompasses a range of service providers such as broker-dealers, financial planners, and record keepers.

A variety of factors contribute to the complexity involved in 401(k) plans. One is the number of different services and providers that the plan may need.[110] The size of a 401(k) plan can cut both ways in terms of complexity. The problem for small plans is that they need many of the

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[109] *See* Davis, *supra* note 73, at 1028 (explaining that approximately 96% of all individuals actively participating in 401(k) plans have both the right and the responsibility to choose how to invest their account assets).

[110] *See* Hutcheson, *supra* note 3, at 344-47.

same services and must meet many of the same compliance requirements as large plans but have fewer participants and lower levels of plan assets to bear those costs.[111] Larger plans tend to have lower per-participant fees because of the economies of scale those plans can achieve.[112] Large plans may be challenged, though, to meet the diversity of interests that naturally occurs among a large participant population. Finally, as employers examine their plan costs and compare those costs with those of other plans, the employers must consider the qualitative differences among the plans. An employer's fiduciary obligation does not require it to offer a low-cost plan. Instead, it requires the employer to act prudently and to ensure the plan service providers are not overcompensated for the services that they render.[113]

A concern related to complexity and limited employer expertise is that employers suffer from information asymmetry on revenue sharing and other compensation and fees in the investment industry as compared to plan service providers and mutual funds. The 2012 GAO report found that some plan sponsors were not aware of financial arrangements among service providers and investment products or, if generally aware, did not understand the amount or use of those fees.[114] Some of the GAO's findings are astonishing in the extent to which employers are unaware of or do not consider revenue-sharing when making plan-related decisions. Almost half of the surveyed plan sponsors did not know if revenue-sharing occurred in their 401(k) plan.[115] And a number of employers that knew revenue sharing occurred within their plan admitted they did not consider the revenue sharing compensation when selecting plan service providers.[116] In some instances, the GAO cross-checked the fee data reported by the employers who participated in its study. One example the GAO gave is that of a large plan that paid 16 times more in fees for administrative services and record-keeping during one year than the employer had reported.[117] Presumably,

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[111] *See* GAO, supra note 27, at 15.

[112] *See id.*

[113] *See* DEP'T OF LABOR, *Meeting Your Fiduciary Responsibilities* 5 (2012) ("[F]iduciaries will want to understand the fees and expenses charged and the services provided"), *available at* http://www.dol.gov/ebsa/pdf/meetingyourfiduciaryresponsibilities.pdf.

[114] *See* GAO, *supra* note 27, at 13-14, 16-21.

[115] *Id.* at 25.

[116] *Id.*

[117] *Id.* at 27.

the employer did not understand the extent of the fees being paid within its plan.

One might assume that the disclosure obligations imposed by the DOL on plan service providers beginning in 2012 would eliminate this asymmetry. However, experts in retirement system fees and the new disclosures explain that service providers are going to considerable lengths to make the mandated fee disclosures difficult for employers to comprehend and analyze.[118] One commentator refers to the disclosures as "*dizzyingly complex*."[119] Discussing plan sponsor obligations in evaluating the disclosures, one plan consultant said "[t]he time it takes – and the attention to detail it takes – is more than sponsors can handle."[120]

Fewer than 60% of full time U.S. workers in the private sector have any access to a retirement plan.[121] A well-functioning regulatory system would encourage employers to increase their sponsorship of retirement plans. Assigning fiduciary obligation and liability for investment selection and monitoring to employers who voluntarily sponsor 401(k) plans does not take advantage of a strong alignment between the interests of employers and employees because no such alignment exists. Nor does designating employers as fiduciaries utilize expertise that they naturally have in running their businesses because few employers naturally develop expertise in the complexities of investment products intended for individuals. It appears that even extensive disclosure requirements may not entirely eliminate information asymmetries that increase the challenges participants face in meeting their ERISA fiduciary obligations.

The observation that employers may not be the best-placed of the entire constellation of actors in the 401(k) plan system to bear the responsibility and liability associated with approval and monitoring of the

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118 *See* Mark Mensack, *The Moral Hazard of Too Big to Jail*, J. COMPENSATION & BENEFITS, May/June 2013, at 42, 44-45. The DOL did not mandate a particular format for these disclosures although it did provide a sample guide for preparation of the initial disclosures. *See generally* Reasonable Contract or Arrangement under Section 408(b)(2) – Fee Disclosure, 77 Fed. Reg. 5632, 5658-59 (Feb. 3, 2012) (to be codified at 29 C.F.R. pt. 2550).

119 Mensack, *supra* note 118, at 45.

120 Lee Barney, *The Moment of Truth,* PLANADVISER (Feb. 2013), available at http://www.planadviser.com/MagazineArticle.aspx?id=10737418889&magazine=10737418887.

121 Alicia Munnell et al., *The Pension Coverage Problem in the Private Sector*, CTR. FOR RETIREMENT RES. AT B.C. (Sept. 2012), *available at* http://crr.bc.edu/wp-content/uploads/2012/09/IB_12-16.pdf.

use of revenue sharing is not incompatible with a regulatory system that appropriately protects employees. Instead the observation provides a rationale for a careful examination of that constellation of actors and the various roles they should play in a properly performing 401(k) system.

B. PROPOSALS TO REALLOCATE FIDUCIARY RESPONSIBILITY

Numerous commentators and policy makers have offered proposals intended to improve the 401(k) system. Some of those suggestions are incremental and would have little or no effect on employer responsibility for the use of revenue sharing.[122] Other suggestions, some of which I categorize below based on their approach to investments and briefly discuss, would dramatically change the DC plan landscape. All of the proposals discussed below address broad, systemic problems in the U.S. DC system. However, I only discuss their implications for employer fiduciary responsibility for plan investments.

In one category of proposals the federal government, or a committee appointed by the government, would assume total or primary responsibility for selection of the investments to be held in DC accounts. Professor Theresa Ghilarducci has offered a schematic for a system that would entirely replace the current DC system, which she calls Guaranteed Retirement Accounts (GRAs).[123] The board of the Thrift Savings Plan (TSP), which administers and invests the DC accounts of federal employees, would invest GRA assets.[124] Professor Ghilarducci's plan would guarantee a three percent investment return in GRAs.[125] During periods of economic stress, GRA assets and the three percent return would

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[122] *See, e.g.*, Colleen E. Medill, *Targeted Pension Reform,* 27 J. LEGIS. 1, 3 (2001) (proposing closure of loopholes in the tax system that result in benefits being lower than they otherwise would be for lower wage workers); Michael W. Melton, *Making the Nondiscrimination Rules of Tax-Qualified Retirement Plans More Effective,* 71 B.U. L. REV. 47, 50 (1991) (arguing that tax incentives are not sufficient to induce low-income workers to save for retirement); *see also* Paul M. Secunda, *401(k) Follies: A Proposal to Reinvigorate the United States Annuity Market,* 30 A.B.A. SEC. TAX'N NEWSQUARTERLY, Fall 2010, at 13, 14-15 (arguing for tax law changes to require 401(k) plans to offer annuitized distribution options).

[123] TERESA GHILARDUCCI, WHEN I'M SIXTY-FOUR: THE PLOT AGAINST PENSIONS AND THE PLAN TO SAVE THEM 262 (2008).

[124] *Id.* at 264-65.

[125] *Id.* at 265.

be protected. On the other hand, the accounts would receive only limited returns during robust financial market periods. Employers would have no responsibility or liability for the investments held in GRAs.

Professor Jeff Schwartz has proposed a government-run system of individual accounts that, like Professor Ghilarducci's, would replace 401(k) plans.[126] One role of the government would be to designate a private sector fund manager to invest account assets, although Professor Schwartz allows that the system may provide some opportunity for employees to select their own investments.[127] The default investment product to be managed by the government-appointed manager would consist of a portfolio made up of a U.S. equity index fund and treasury-inflation protected securities (TIPS).[128] While not formally promising a guaranteed minimum investment return, the use of TIPS is intended to provide a "guarantee[d] return of principal in real terms at retirement."[129] The allocation between the equity index fund and TIPS, and thus the effective guarantee, would vary according to employee age.[130] As with Professor Ghilarducci's plan, employers would not have any role or liability in the selection of account investments.

A second category of reform proposal would retain many of the contours of the existing 401(k) plan system but would make changes to the investment component of the system. One plan receiving significant attention is sponsored by Senator Tom Harkin.[131] If adopted, his proposal would require any employer not offering a DB or DC plan that meets minimum criteria to enroll employees into a newly-created type of private sector pension plan, a Universal, Secure, and Adaptable (USA) Retirement Fund.[132] Senator Harkin's proposal only provides the broad details of how USA Retirement Funds would work. There are indications that employees would have individual accounts because the proposal states that "[t]he amount of a person's monthly benefit would be determined based on the total amount of contributions made by, or on behalf of, the participant and

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[126] Jeff Schwartz, *Rethinking 401(k)s,* 49 HARV. J. ON LEGIS. 53, 74-78 (2012).

[127] *See id.* at 85.

[128] *Id.* at 83.

[129] *Id.*

[130] *Id.*

[131] *See generally* TOM HARKIN, U.S. SENATE COMM. ON HEALTH, EDUC., LABOR & PENSIONS, THE RETIREMENT CRISIS AND A PLAN TO SOLVE IT (2012), *available at* http://www.harkin.senate.gov/documents/pdf/5011b69191eb4.pdf.

[132] *Id.* at 1, 6-7.

investment performance over time."[133] However, the proposal also contemplates risk sharing, the type and amount of which is ambiguous. The risk sharing delegates to the trustees of each fund the flexibility to gradually increase or decrease benefits depending on investment performance.[134] Such sharing of risks is incompatible with a system that calculates individual benefits based purely on account balances.

The fiduciary responsibility for USA Retirement Funds would lie with the fund trustees charged with plan management.[135] Trustees would represent various constituencies: employees, retirees and employers.[136] USA Retirement Funds would be licensed by an unspecified entity.[137] Employers would not have any fiduciary liability for the selection of a USA Retirement Fund for their employees and, in fact, would be permitted to "use the 'default' fund identified for the region, industry, or through collective bargaining."[138] Presumably a federal agency would determine the default fund for various regions and industries. Senator Harkin's plan does not seem to address the responsibility and liability for investments of employers that choose to offer their own DC plan rather than enrolling their employees in a USA retirement fund.

Elsewhere, I have proposed a system that is similar to Senator Harkin's in that it would leave intact much of the present 401(k) framework.[139] It would decrease employer liability for investment selection and provide added incentives for plan sponsorship by offering additional liability protections for small employers.[140] My proposal is centered on a new type of investment product, Safe Harbor Automated Retirement Product (SHARPs).[141] In lieu of employer fiduciary obligation for SHARPs, I propose a two-part mechanism consisting of: (1) assigning fiduciary responsibility to the investment managers and fund directors that determine and implement a SHARP's investment strategy; and (2) licensing by and reporting to a federal regulatory agency. Disclosure

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133 *Id.* at 6.
134 *Id.* at 7.
135 *Id.* at 6.
136 *Id.*
137 *Id.* at 7.
138 *Id.*
139 Muir, *supra* note 7, at 49.
140 *Id.* at 50.
141 *Id.* at 7.

requirements would promote the ability to make competitive comparisons among SHARPs.[142]

The investment strategy of SHARPs is critical to employees' wealth accumulation. SHARPs would be permitted to use any investment strategy that would currently meet the Qualified Default Investment Alternative requirements imposed by the DOL as part of a safe harbor for default plan investments in automatic enrollment 401(k) plans.[143] To drive investor-focused performance and low fees, the investment managers of SHARPs would have fiduciary liability to act in the best interest of the participants, including determination, disclosure, and implementation of an appropriate asset allocation strategy.[144] As a final check, the board members of a SHARP would be responsible for its compliance with regulatory standards and its disclosed strategy.[145]

My SHARPs proposal is based, with appropriate adaptations for the U.S. system, on Australia's implementation of MySuper investment products. Elsewhere, I have described Australia's approach to private sector pension provision in greater detail.[146] Relevant here is that after the global financial crisis Australia undertook a review of its retirement system.[147] The final reform recommendations were extensive.[148] One component addressed the default investment vehicles used for the accounts of employees who do not designate their investment choices. Default investment products are in extensive use in Australia because many Australians are passive with respect to their investments, do not make active plan choices, and have limited financial literacy.[149] In the reformed system, MySuper products will be the only permitted type of default investment product. In addition, employees who wish to make explicit

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[142] *Id.* at 51.

[143] For an explanation of both QDIAs and automatic enrollment 401(k)s, see *id.* at 53.

[144] *Id.* at 51.

[145] *Id.*

[146] For a discussion of the system and the values it represents, see Dana M. Muir, *Building Value in the Australian Defined Contribution System: A Values Perspective,* 33 COMP. LAB. L. & POL'Y J. 93 (2011).

[147] SUPER SYS. REVIEW PANEL, SUPER SYSTEM REVIEW FINAL REPORT pt. 1 (2010), *available at* http://www.supersystemreview.gov.au/content/downloads/final_report/part_one/Final_Report_Part_1_Consolidated.pdf.

[148] *Id.* at 24–60.

[149] *Id.* at 8–9.

investment decisions may designate a MySuper product to receive their retirement plan contributions.[150]

The regulatory framework is relatively simple. The Australian Prudential Regulatory Authority (APRA) will gather and make public data on MySuper product performance and fees to facilitate competition among the offerings.[151] The regulatory approach to MySuper default products imposes an enhanced set of duties on MySuper fund entity trustees (sometimes referred to as corporate trustees)[152] and on the boards that govern the entity trustees.[153] Employers play no significant role and have no significant liability in this system. The enhanced obligations of MySuper entity and individual trustees essentially will operate as an additional layer of duties on top of the basic set of requirements that applies to all entity trustees of funds that hold retirement assets.[154] In addition, trustees must be licensed and meet specific standards with respect to the operation of a MySuper product.[155]

Unlike the employer-based retirement system in Australia, the U.S. regulatory system currently relies on employers as the primary gatekeepers and decisionmakers for 401(k) plan investments. This approach is a relic of the period when DB plans were the predominant type of retirement plan. In the context of the current DC system, employers' interests do not

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[150] *Id.* at 10.

[151] *See* TREASURY, COMMONWEALTH OF AUSTL., STRONGER SUPER: INFORMATION PACK 4 (2011), *available at* http://strongersuper.treasury.gov.au/content/publications/information_pack/downloads/information_pack.pdf.

[152] *See* Mark Blair & Ian Ramsay, *Collective Investment Schemes: The Role of the Trustee,* 1 AUSTL. ACCT. REV. 10, 17 (1992) (noting that a trustee is required in order to receive certain tax benefits); Jeremy Cooper, *Super for Members: A New Paradigm for Australia's Retirement Income System,* 3 ROTMAN INT'L J. PENSION MGMT. 8, 13 (2010).

[153] *See* SUPER SYS. REVIEW PANEL, SUPER SYSTEM REVIEW FINAL REPORT pt. 2, at 12–14 (2010), *available at* http://www.supersystemreview.gov.au/content/downloads/final_report/part_two/Final_Report_Part_2_Consolidated.pdf; TREASURY, COMMONWEALTH OF AUSTL., *supra* note 151, at 19–20.

[154] MySuper entity trustees will be required to: promote the financial interests of MySuper members, in particular net returns; annually assess sufficiency of scale; and include in their investment strategy an investment return target and level of risk for MySuper members. *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth) div 6 (Austl.).

[155] *See* Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2011 (Cth) (Austl.), *available at* http://www.comlaw.gov.au/Details/C2011B00234.

strongly align with the interests of employees who invest through those plans, typically do not have specialized expertise in investment products targeted to individual investors, and suffer from information asymmetry as compared to 401(k) plan service providers and entities such as mutual funds that invest account assets.

A number of the proposals for reform of the U.S. 401(k) system advocate decreasing the responsibility and liability employers face in offering their employees the opportunity to use DC plans as a component of the employees' pursuit of lifelong financial security. Revenue-sharing is a good example of the challenges employers confront in establishing 401(k) plan investment menus, monitoring those menus, and overseeing the compensation of plan service providers. None of the proposals discussed here would leave plan participants unprotected. Instead, the proposals divide responsibility for investment oversight in various ways among the federal government and the providers of investment products and 401(k) services.

V. CONCLUSION

Revenue sharing in 401(k) plans dates at least to the early 1990s. It took some time, though, before revenue-sharing began to receive significant attention from others than those who paid or received it. The DOL recently has increased disclosure obligations to provide more transparency on the compensation, including from revenue-sharing, which service providers derive from 401(k) plans.

In addition to the disclosure obligations, ERISA imposes fiduciary obligations and liability on employers for the selection and monitoring of 401(k) plan investments and service providers. Cases brought by participants alleging excessive investment fees and service provider compensation have highlighted these obligations, including the role played by revenue sharing. But workers struggling to meet their survival needs and save for the future deserve a better system. The current fiduciary structure serves to discourage employers, particularly small employers, who have neither the expertise nor the time to understand financial products targeted at individual investors and the compensation practices, including revenue-sharing, used in the financial sector, from establishing a 401(k) plan. In today's competitive business environment, even large employers may be reluctant to develop the expertise necessary to meet ERISA's substantive fiduciary standards. In short, revenue-sharing is but one example, albeit an important one, of why the US needs to carefully evaluate its approach to building retirement wealth for its workers.