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Testimony Before the ERISA Advisory Council's Working Group on Fiduciary Responsibilities Update and Revenue Sharing

On behalf of CIKR

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Good afternoon. My name is Sam Brkich, and I am Vice President at The Newport Group. My firm is a leading national provider of retirement plans and investment advisory services. I am here today to present the view of the Council of Independent 401(k) Recordkeepers (CIKR), where I currently serve as a member of the Board of Directors.

CIKR is a national organization of 401(k) plan service providers. CIKR members are unique in that they are primarily in the business of providing retirement plan services as compared to financial services companies who primarily are in the business of selling investments. As a consequence, the independent members of CIKR offer plan sponsors and participants a wide variety of investment options from various financial services companies without an inherent conflict of interest. By focusing their businesses on efficient retirement plan operations and innovative plan sponsor and participant services, CIKR members are a significant and important segment of the retirement plan service provider marketplace. Collectively, the members of CIKR provide services to approximately 68,000 plans covering 2.8 million participants and holding in excess of $120 billion in assets.

My employer, The Newport Group, is a founding member of CIKR. The Newport Group employs more than 375 staff, including actuaries, accountants, attorneys, benefit consultants, investment advisers, plan administrators, technology and communication experts. Newport administers approximately 1700 qualified and non-qualified retirement plans with client assets exceeding $19 billion.

CIKR applauds the Council's leadership in examining the changes to the fiduciary responsibility rules affecting both defined benefit and defined contribution plans under the Pension Protection Act of 2006 (PPA) and analysis of revenue sharing issues. I will focus my testimony today on the fiduciary issues surrounding revenue sharing, current

revenue sharing practices and preliminary recommendations to the Department of Labor (DOL) on potential guidance on revenue sharing arrangements.

Background

As you know, there has been an increasing focus on revenue sharing in the retirement services industry, both at the regulatory and practitioner level. In general, the scrutiny involves whether mutual fund fees are too high, and whether the revenue sharing received by service providers exceeds the value they provide and/or is being properly disclosed to plan sponsors and participants.

Revenue sharing is a very common practice, but disclosure of that revenue to clients varies widely. It is our understanding that a number of non-fiduciary service providers do not offset their fees by the revenue sharing they receive or rebate "excess" revenue sharing back to their clients. CIKR members are in agreement that excess revenue sharing should be returned to the participants. At the conclusion of my remarks, I have included recommendations for the treatment of excess revenue sharing, including recommendations for when excess revenue sharing would constitute a plan asset and how any excess revenue sharing may be allocated among plan participants.

The Newport Group's standard practice is to disclose fee schedules and revenue sharing to clients, apply any revenue sharing to the payment of quoted fees and to rebate excess revenue to clients. Over the last few years we have transitioned our plans and pricing protocol to a "gross to net" fee schedule. This model allows Newport to fully disclose each line item on the invoice and then use the agreed upon fee schedule to determine which fees (trustee, recordkeeping, auditor, etc.) are able to be offset by the mutual fund subsidy collected. If, and when, there is excess subsidy, Newport's practice is to credit these "excess" funds to a plan's management account. Newport will then deliver a form letter to the client advising them of the "credit" and the administrator discusses how the subsidy should be utilized.

Issues

There are a number of unsettled issues surrounding revenue sharing. Does revenue sharing constitute a plan asset? Does a plan sponsor breach its fiduciary duties if it engages a provider who receives "excessive" revenue sharing? Is the exemption from the prohibited transaction rules for reasonable services arrangements no longer available if such disclosure is not made? If so, is the provider who fails to make such disclosures liable for any excise tax?

Additional questions arise as to the handling of excess revenue sharing. What are the permissible uses of excess revenue sharing? Is it a prohibited transaction for a service provider to credit an excess back to the plan's trust or to use the excess to pay plan expenses (including any unpaid provider fees) that would otherwise be paid by plan assets? Can the excess be reallocated to the accounts of participants in the plan, and on what basis? If the revenue is to be credited back to the plan, is there a timeframe within

which the funds must be transferred to the plan's trust, or can the excess be retained by the service provider?

Guidance from DOL would ideally address whether providers can or must use excess revenue sharing to benefit plans, whether any excess needs to be held in trust and how quickly following the receipt it needs to be put in trust, and whether the receipt of revenue sharing needs to be disclosed on Schedule C of the 5500. If instead the DOL takes the position that it is a prohibited transaction to rebate excess revenue, should providers change the way clients are charged (quoting net fees rather than gross fees less estimated revenue sharing), and retain any excess revenue sharing? Further, although fiduciary issues predominate, a ruling from the Internal Revenue Service on any effect of a rebate on the tax-qualified status of the plan and the characterization of such a rebate could also be helpful.

The balance of this memorandum summarizes the way in which independent providers such as The Newport Group attempt to address revenue sharing issues and some thoughts on how these issues may be approached. There are some questions that are not answered by existing guidance. An Exhibit summarizes the various DOL letters that discuss receipt of revenue sharing by service providers.

Existing DOL Guidance

The DOL has issued four opinion letters, two information letters, and an individual prohibited transaction exemption that analyze whether a service provider's receipt of revenue sharing from mutual funds in which plan assets are invested is a violation of ERISA Sections 406(b)(1) and/or (b)(3). A synopsis of each of these letters, and a summary of their underlying facts, is attached as Exhibit A.

The rulings contained in the letters provide the following guidance:

- It is a violation of ERISA Sections 406(b)(1) and (b)(3) if a plan fiduciary exercises authority or control over the assets of the plan and causes the plan to invest in mutual funds that will pay additional fees to the fiduciary. Conversely, it is not a violation of these sections if a plan fiduciary receives fees from mutual funds, so long as the fiduciary does not use any authority or control to cause the plan to invest in the funds. Nor is it a violation of these sections if a non-fiduciary service provider receives fees from mutual funds.

    -- A directed trustee is a fiduciary. If a directed trustee's services to a plan include making recommendations regarding the selection of or investment in mutual funds, it is exercising authority or control over the assets of the plan.

    -- A service provider that has the ability to delete or substitute funds from the list of funds available for selection by plans is not a fiduciary, so long as the provider provides advance notice of the fund changes, an independent plan fiduciary decides whether to accept the fund change, and the service provider

gives the plan a reasonable period of time to convert to a new provider if the changes are rejected.

-- A service provider is not a fiduciary of a plan merely because it is affiliated with another service provider who is a fiduciary.

-- A directed trustee is not exercising control over the assets of a plan simply because it has the ability to delete or substitute funds, so long as advance notice of changes are provided, an independent fiduciary makes all decisions, and the trustee gives the plan a reasonable period of time to convert to a new provider if fund changes are rejected.

- If a fiduciary exercises authority or control over plan assets and causes the plan to invest in mutual funds that will pay the fiduciary additional fees, the fiduciary must (1) disclose the extent to which it may receive fees from the mutual funds, (2) agree to either reduce the fees owed to it by the plan by any fees received from the mutual funds, use the fees to pay other plan expenses, or credit the fees to the plan, and (3) ensure that any fees from the mutual funds that exceed the fees owed to it by the plan are applied for the benefit of the plan, either by using them to pay other expenses owed by the plan or by crediting them to the plan.

- Plan fiduciaries have a duty under ERISA Section 404(a)(1) to assure that compensation paid directly or indirectly to service providers by the plan is reasonable, taking into account the services provided as well any fees or other compensation received by the providers in connection with the investment of the assets of the plan.

Note, however, that the rulings do not address whether revenue sharing arrangements might violate ERISA Section 406(a)(1)(C) (requiring that plans pay no more than reasonable compensation to service providers). This is because the DOL views that as an inherently factual question and will not issue opinion letters on the topic.

Newport's Service Models

Newport Retirement Services, Inc. ("NRS") and Newport Group Securities, Inc. ("NGS") (collectively, "Newport") are privately-owned corporations under common control. NRS provides non-discretionary recordkeeping and administrative services support to numerous employer-sponsored retirement plans qualified under Code Section 401(a) (the "Plans"). The Plans are subject to the provisions of Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"). Recordkeeping services include processing financial transactions (contributions to the plan, disbursements and distributions from the plan, investment buys and sells) and maintaining plan records at the participant level. Administrative services include document services, compliance support and testing, preparation of governmental reports, etc.

NGS is a broker-dealer and registered investment advisor. The Plans can contract with NGS to provide either fiduciary or non-fiduciary investment services. Fiduciary services include providing advice regarding the investment funds to be included in the Plan's investment menu, and assisting the Plan sponsor in developing investment allocation models for use by participants in the Plan. Although all investment decisions are made by a Plan fiduciary, rather than by NGS, NGS understands that its advice will be used as the primary basis on which the Plan fiduciary makes investment decisions. NGS can also provide non-fiduciary investment services, which would include providing information regarding investment funds to a Plan fiduciary.

NRS and NGS work closely with various outside third parties to determine the service needs of the Plans. Depending on the needs of the Plan, Newport may provide (1) recordkeeping services only, (2) recordkeeping and administrative services only, (3) recordkeeping and investment advisory services only, or (4) recordkeeping, administrative and investment advisory services. Newport maintains fee schedules that describe the fees that will be charged to a Plan for the services it will provide. These fees are disclosed to the Plans prior to engaging Newport.

Receipt of Revenue Sharing.

In the 401(k) provider industry, "revenue sharing" typically refers to sub-transfer agent ("sub-t/a") fees or shareholder servicing fees. Revenue sharing is paid by many (but not by all) mutual funds. In addition, mutual funds may pay commissions in the form of finders' fees or 12b-1 fees. The fees paid are typically a percentage of the assets invested with the fund, as negotiated by potential fund distributors in exchange for including the fund on their platforms. However, under some arrangements revenue sharing is based on the number of participants invested in each fund.

As described in more detail below, Newport receives sub-t/a fees from the funds (directly or indirectly), for which it provides what are generally referred to as shareholder services. Those services might include accounting services related to the purchase by a plan of shares of the fund, processing sales and purchases of fund shares, providing fund enrollment materials to participants, and providing participant level accounting of transactions within mutual funds including monitoring for redemption fees.

The assets of the Plans serviced by Newport are held by a variety of custodial institutions (also referred to as trading or trust partners). Such custodians have selling agreements with the funds and receive commissions from them. The custodians retain a small percentage of the subsidy, and pass the remainder on to Newport. The portion allocated to the custodians is not to compensate them for their custodial services, but rather to compensate them for administration associated with collecting and disbursing the revenue. These administration fees vary from 5-10% of the amount collected). Most sub-transfer agent fees are paid directly to Newport, although a minority are paid to our custodial partners and passed through to Newport.

It is not uncommon for there to be excess revenue sharing, although the amount of the excess normally is small. As a rule of thumb, excess revenue can be expected if the average account balance of the Plan exceeds $40,000 (not taking into account the investment advisor fee).

Disclosure of Revenue Sharing, Fee Offsets and Revenue Sharing Rebates.

Newport utilizes a **"gross to net"** standard for disclosing revenue sharing. Gross fees are disclosed in advance to the client, along with an estimate of the expected revenue sharing Newport will receive based on the anticipated investment menu for the Plan. Newport has agreed to offset its fees by any revenue sharing it receives. The Plan is only responsible for paying the difference between the scheduled service fee and the revenue sharing receipts. If the revenue sharing receipts exceed the scheduled service fee, the excess is held in a Newport account pending direction from the plan as to its disposition.

Gross fees and revenue sharing receipts are separately identified on the client's invoice. If during the period revenue sharing exceeds gross fees, an additional item is added to the invoice which identifies the amount of excess revenue sharing. This item states that these funds will be remitted back to the trust. Newport currently remits excess revenue sharing to the plans quarterly.

The Plan may direct that the excess be used to pay other Plan expenses (for example, fees for the required audit). The Plan may instead direct that the excess be credited to its trust and allocated to the accounts of participants.

Revenue Sharing Broken Down by Service Model. The types of revenue sharing we receive, and the process by which the revenue is disbursed to the parties involved in servicing the Plan under Newport's various service models are as follows:

- **Recordkeeper Only**. Newport may receive sub-t/a and/or 12b-1 fees, depending on the role Newport's partner is serving. If the partner is serving as a Registered Investment Advisor, Newport receives both sub-t/a and 12b-1s (because the RIA's fee is a wrap fee that is in addition to the 12b-1s). If the partner is instead serving as a broker, the partner will receive the 12b-1s directly as compensation for its services, and Newport will receive only the sub-t/a fees.

  Under this servicing model, Newport invoices the outside TPA for our services. Our fee includes an amount to compensate the custodian for its custodial services. With some TPAs, the invoice will include our fees for multiple plans, with detail for each plan. In other cases, we may have a contract with the TPA for a particular plan and our invoice will be for a single plan only. In either case, our fee is offset by any revenue sharing we received for the plan, and that offset is identified on the invoice. The TPA will then bill the client for its fees (which would include our "offset" fee) or may submit a fee request to us to have the fee deducted from the Plan. If the partner is serving as an RIA, the partner's fee may be included in our invoice, separately identified, or the RIA may bill the client

directly; it depends on the arrangement we have with the partner. If our revenue sharing exceeds the amount being billed to the TPA, the excess is identified on the invoice, and the client can elect to pay some or all of the TPA and/or RIA fee with the excess. Under this model Newport does not have direct contact with the client; it is up to the TPA to disclose the excess to the client.

- **Recordkeeper and Administrator**. The process is the same except that Newport is not billing an outside TPA for Newport's services – the invoices are sent directly to the client.

- **Recordkeeper and Investment Advisor**. A third party TPA retains Newport. The process would generally be as described under Recordkeeper Only. However, because NGS is the investment advisor, Newport will have a direct contractual relationship with the client as well, and would bill the client directly for advisory services. Excess revenue sharing would be applied as provided in the service agreements to Newport recordkeeping fees, custodial fees, and NGS investment advisory fees.

- **Recordkeeper, Administrator and Investment Advisor**. Our partner can be either an advisor (RIA) or a broker. If the partner is an RIA, his fee is a wrap fee; if a broker, he is compensated with 12b-1 fees. In this scenario, Newport bills the client directly for its services, but two separate invoices are produced, one for RK and administrative services and one for advisory services. If the partner is an RIA, his fee generally is billed directly to the client, but as an alternative, it may be included in our invoice as a separate item. In this scenario, Newport may ask the partner serving as broker-dealer (not as an RIA) to accept a percentage of our advisory fee as compensation, rather than being compensated by 12b-1s, so that the investment menu is not driven by funds that pay 12b-1s. If the partner agrees, he would be paid by us and the arrangement would be disclosed to the client during the sales process (i.e., that a part of the fee they pay to us will be paid by us to the broker), but there would not be a separate line item on the invoice for the payment to the broker. Again, excess revenue sharing would be applied first to our recordkeeping fees, then to custodial fees, then to the investment advisory fees.

Legal/Policy Considerations

An investment adviser acting as a fiduciary is required to disclose revenue sharing arrangements and apply any revenue received by it for the benefit of the plan (either by offsetting its own fees, paying other plan expenses, or crediting the revenue to the plan), in order to avoid violations of ERISA Sections 406(b)(1) and (b)(3).

Note that a requirement to disclose and offset would not apply to a nonfiduciary provider, at least with respect to the ERISA sections cited above. Revenue sharing likely could be retained so long as the provider does not exercise any control over the assets of the plan (an affiliation with a fiduciary provider, by itself, would not appear to cause the non-

fiduciary provider to become a fiduciary of the plan or to be treated as exercising control over the assets of the plan).

It is not clear to what extent there could still be a violation of ERISA Section 406(a)(1)(C) if a non-fiduciary provider retains the revenue sharing payments that have not been disclosed. Under ERISA Section 406(a)(1)(C), plan sponsors are prohibited from causing a plan to contract with a third party service provider, unless the compensation paid by the plan to the service provider is reasonable. The question is whether amounts received by the provider from mutual funds are amounts paid by the plan. In Opinion Letters 97-15A and 97-16A, the DOL appeared to take the position that revenue generated by a plan's investment in a mutual fund that are paid to a service provider are amounts being paid by the plan indirectly. If that interpretation is correct, then even in those circumstances where a provider is not legally required to use excess revenue sharing for the benefit of the plan under ERISA Sections 406(b)(1) or (b)(3), it may be required to give up such excess in some way (a credit toward other expenses, for example) to avoid violating ERISA Section 406(a)(1)(C). Alternatively, it may be that the point being made by the DOL was simply that any fees paid by trust assets to a service provider cannot exceed the difference between the reasonable value of those services and the amounts the service provider is receiving from other sources in connection with the investment of the plan's assets. In either case, it would seem that the amounts received indirectly through revenue sharing would need to be disclosed to the independent fiduciary in order for the statutory exemption under ERISA Section 408(b) for reasonable service arrangements to be available.

If a provider is not required to apply revenue sharing to its fees, it can nevertheless agree to do so and use any excess revenue sharing to pay other expenses of the plan and/or credit the excess to the plan. ERISA Opinion Letter 97-15A (the Frost letter) and the PWBA information letter to First American Bank implicitly support this approach. In those letters, the DOL did not raise any concerns regarding the crediting of revenue sharing by Frost or First American Bank to its client plans even in those situations where the providers were not exercising authority or control over the assets of the plans. Note, however, that if the agreement calls for a rebate to the plan, the excess amount may constitute plan assets by virtue of the agreement between the parties. See, for example, ERISA Opinion Letter 2005-08A and other opinion letters referenced therein, including footnote 4 which states "If an employer takes steps that cause the plan to gain a beneficial interest in particular assets, under ordinary notions of property rights (e.g., causing the plan to be the named policyholder or using trust assets to pay the entire premium) such assets would become plan assets."

Recommendations

None of the existing guidance directly addresses the legal considerations for handling revenue sharing, for rebating excess revenue sharing to a plan or how such rebates may be used. Members of CIKR recommend that DOL issue guidance, together with Treasury as necessary, as follows:

- Service providers may agree, as part of the service arrangement that meets the exemption of ERISA Section 408(b), to rebate excess revenue sharing to the plan trust within the times specified in the services agreement. The time and manner in which rebates are deemed to constitute plan assets and credited to the plan should be part of the independent fiduciary's determination that the services arrangement is reasonable.
- If revenue sharing is not rebated, the determination of whether the arrangement is reasonable should be based on estimates of expected revenue sharing disclosed by the provider and prior to entering into the arrangement. The provider should have a continuing obligation to update such information if plan assets have increased significantly or if there has been a material change to the investment menu.
- The agreement to rebate excess revenue sharing to the plan and the payment of such amounts to the trust should not constitute a prohibited transaction under ERISA or the Code. The plan asset rules should clarify that excess revenue sharing becomes a plan asset at such time as such excess is required to be reimbursed to the trust under the terms of the service agreement with the plan sponsor.
- Plans should be permitted to allocate excess revenue sharing among participant accounts on a reasonable basis. Theoretically, the possibilities include (1) allocating the funds to all participants in proportion to their account balances, i.e., as earnings, regardless of whether they were invested in the funds paying the revenue, (2) allocating the funds to participants invested in the funds paying the revenue, as earnings, in proportion to their relative investments in those funds, or (3) allocating the funds as an additional employer contribution on the basis of account balances or deferrals, as applicable. Option 2 provides the most equitable result and is one that the industry should be working toward. However, Option 2 requires systems to be constructed that will enable the trading platform to report the amount of revenue sharing or expense reimbursements attributable to a given participant's allocation to a given fund. Until such systems are established, it may be necessary to use alternative procedures, including Option 1 or reasonable approximations of Option 2. Members of CIKR are in agreement that Option 3 raises potential prohibited transaction concerns to the extent it would allow a sponsor to discharge a contribution obligation with assets generated by participant investments.
- Finally, a ruling from the Internal Revenue Service on the character of the funds for qualification purposes would also be helpful. For example, are the rebates to be considered as annual additions, earnings, "settlements" or some other type of addition to the plan? From the standpoint of administration, CIKR members recommend treating the rebates as earnings, consistent with the investments that generated the excess revenue share.

Exhibit A
Review of DOL Guidance Regarding Revenue Sharing

ERISA Opinion Letter 97-15A issued 05/22/1997 (the so-called "Frost" letter)

Synopsis. It is a violation of ERISA 406(b)(1) or (b)(3) if a plan fiduciary recommends that the plan invest in mutual funds that in turn pay the fiduciary 12b-1 and sub-t/a fees, unless the fiduciary discloses the fees and uses the revenue to offset fees owed by the plan to it or other service providers or credits the revenue to the plan, and unless any revenue in excess of its fees are credited to the plan. It may also be a violation of ERISA 406(b)(1) and (b)(3) if a fiduciary has the right to change the list of available funds and receives revenue from those funds when a plan invests in them. Of particular interest is the language in the final substantive paragraph of the opinion, which warns that plan fiduciaries must ensure that the compensation paid directly or indirectly *by the plans* to Frost is reasonable, taking into account the services provided and the fees received by Frost from the mutual funds. This last paragraph strongly suggests that the DOL views these mutual fund payments as compensation paid indirectly by the plans, i.e., that the payments are plan assets.

Facts. Frost was a bank that served as a directed trustee for various retirement plans. It had agreements with various mutual fund families under which it would make those funds available to plan sponsors, and would receive fees from the mutual funds in exchange for providing shareholder services, including 12b-1 and sub-t/a fees. In some instances, Frost made recommendations to plan sponsors regarding the advisability of selecting a fund, while in others no recommendations were made. The arrangements with the mutual funds were fully disclosed, and the trustee agreement provided that any fees received would be used to benefit the plan, either by offsetting the fees against its trustee fee or against fees owed to third-party recordkeepers, or by crediting the fees directly to the plan, and that the plan would be entitled to any mutual fund fees that exceeded amounts owed to Frost. Frost requested an opinion that its receipt of fees from the mutual funds did not violate ERISA Sections 406(b)(1) or (b)(3) (prohibiting fiduciaries from dealing with plan assets for their own interest or from receiving any consideration for their own account in connection with a transaction involving plan assets). Frost was found to be a fiduciary of the plans because it was a trustee. The DOL noted that it would typically be a violation of ERISA 406(b)(1) if a fiduciary recommends investing in a fund that pays additional fees to the fiduciary. However, because the receipt of the fees was fully disclosed and because fees would be used to offset fees owed to Frost and that the plan would be entitled to any excess fees, no violation had occurred. It reached a similar conclusion with regard to ERISA 406(b)(3). The DOL also stated it would not be a violation of either section if Frost was acting solely as a directed trustee and did not recommend investing in the funds, but that because Frost retained the right to add or remove mutual fund families, it could not conclude that Frost had not exercised

any discretionary authority or control that caused the plans to invest in those mutual funds.

ERISA Opinion Letter 97-16A issued 05/23/1997 (the so-called Aetna letter)

Synopsis. It is not a violation of ERISA 406(b)(3) if a non-fiduciary service provider receives fees from mutual funds in which its client plans invest. A service provider is not a fiduciary merely because it is related to a plan fiduciary. A service provider is not a fiduciary merely because it controls the list of funds from which plan sponsors can choose, provided that an independent plan fiduciary makes the decision whether to accept or reject fund changes, and provided the service provider gives advance notice of any fund changes and a reasonable period of time to find a new provider if the plan sponsor rejects the change. Again, the DOL stresses that plan fiduciaries must ensure that the compensation paid directly or indirectly *by the plans* to ALIAC is reasonable, taking into account the services provided and the fees received by ALIAC from the mutual funds. This last paragraph strongly suggests that the DOL views these mutual fund payments as compensation paid indirectly by the plans, i.e., that the payments are plan assets.

Facts. ALIAC is a life insurance company that offers a bundled services package to sponsors of participant-directed defined contribution plans, including a menu of investment options comprised of affiliated mutual funds, affiliated insurance products, and unaffiliated mutual funds. Trustee services are provided by a bank unrelated to ALIAC. ALIAC does not provide investment advice or recommendations to plan fiduciaries regarding which investment options to select. All decisions regarding investment options are made by independent plan fiduciaries. ALIAC received management fees from the affiliated funds, and an affiliate of ALIAC (ALIC) received management fees from the affiliated insurance products, but no ruling was sought regarding the receipt of those fees. ALIAC also disclosed that it might in the future receive fees from the unaffiliated funds for "marketing services," but no ruling was sought on the receipt of those fees, either. Instead, the focus of the ruling was on ALIAC's receipt of fees from the unaffiliated mutual funds for providing shareholder and other administrative services to the funds, which were paid as administrative expenses or pursuant to a 12b-1 plan by the funds. ALIAC provides existing and prospective clients with a statement disclosing it may receive fees from some of the unaffiliated funds, and describing the services it provides for those fees and the rate of fees paid. The statement also provides a telephone number with which plans can request more detailed information regarding which funds pay fees and what the estimated fees ALIAC receives are. The statement is updated whenever there is a material change. ALIAC has the right to change the list of available unaffiliated funds by providing a minimum of 60 days notice of any changes, and its clients who object to the change are given an additional minimum of 60 days to convert to another service provider. ALIAC requested an opinion that its receipt of fees from the unaffiliated mutual funds did not violate ERISA Section 406(b)(3) (prohibiting

fiduciaries from receiving any consideration for their own account in connection with a transaction involving plan assets). The DOL stated the receipt of fees from a mutual fund by a fiduciary does not violate 406(b)(3) so long as the fiduciary does not cause the plan to invest in the fund through the exercise of authority or control over the assets of the plan. It did not consider ALIAC a fiduciary by virtue of its ability to substitute or delete funds, so long as an independent plan fiduciary makes the decision whether to accept or reject the change, ALIAC provides advance notice of the change and a reasonable period of time to find a new provider if the change is rejected. It also did not consider ALIAC a fiduciary simply by virtue of its affiliation with ALIC, who would be considered a fiduciary to the plans.

PWBA Letter 08/20/1997.

Synopsis. The ABA requested confirmation that the principles enunciated in Advisory Opinions 97-15A and 97-16A would apply in the case of a bank that serves as a directed trustee. The PWBA responded in the affirmative. Thus, a directed trustee who does not offer investment advice, and who controls the available investment options but provides notices of changes and a reasonable time to seek an alternative, would not violate 406(b)(1) or (b)(3) if it received payments from mutual funds in which the funds invest.

PWBA Letter 04/10/1998.

Synopsis. This was a request by First American Bank for an opinion letter that it did not violate ERISA 406(b)(1) or (b)(3) if it received fees from mutual funds in connection with the investment of plan assets in those funds for plans for which it served as directed trustee, in circumstances where in some cases it provided investment advice and in some cases it did not. The DOL chose to respond in the form of an information letter. The facts are virtually identical to the Frost letter.

ERISA Opinion Letter 2003-09A issued 06/25/2003.

Synopsis. It is not a violation of ERISA 406(b)(1) or (b)(3) if a fiduciary of a plan receives fees from mutual funds in which its client plans invest, so long as the fiduciary does not exercise authority or control in causing the plan to invest in the funds. A directed trustee who does not provide investment advice, and does not restrict the fund lineup has not used authority or control to cause the plan to invest in a fund, and can receive fees from the funds. The fiduciary does not have to offset its fees by the revenue received from the funds. The opinion letter does not contain the warning included in 97-15A and 97-16A regarding the need to ensure compensation paid directly or indirectly by the plan is reasonable. Instead, it provides in a footnote that no opinion is expressed as to whether ERISA 408(b)(2) has been satisfied.

Facts. AATSC is a trust company that offers a bundled services product to defined contribution plans. It is a wholly-owned subsidiary of Alleghany, which is the parent to various institutional investment advisers that serve as investment advisor to a number of mutual funds. AATSC has agreements under which it makes mutual funds available for investment by its client plans; the funds include funds for which affiliates serve as investment advisor, as well as funds whose advisors are not related to AATSC. AATSC requires that each client plan offer one or more of the affiliated funds as an investment option. AATSC discloses to each prospective client information regarding each affiliated fund, including (1) the number of actively-managed funds in the same category as the affiliated fund, (2) the fees paid by the affiliated fund in aggregate and separately as investment advisory, 12b-1 and other fees, and (3) information regarding those fees for a spectrum of funds in the same category. The investment options are chosen by plan fiduciaries and the options are not restricted by AATSC (it is an open-architecture system) except that they must include at least one affiliated fund. AATSC charges fees that are based in part on the amount of a plan's assets it expects to be invested in the affiliated funds; the more affiliated funds offered under a plan, the lower fees charged by AATSC. If the plan sponsor deletes an affiliated fund from its investment menu, the services charged by AATSC would be reviewed and the parties would negotiate or the relationship can be terminated by either party. AATSC requested an opinion letter as to whether its receipt of 12b-1 and sub-t/a fees from mutual funds, including affiliated funds, would violate ERISA 406(b)(1) or (b)(3) if the decision to invest in the funds is made by an independent plan fiduciary. Because AATSC served as a directed trustee of the plans, it was found to be a fiduciary. However, because it did not control or reserve the ability to delete or substitute funds, and because investment decisions were made by an independent plan fiduciary, no violation of 406(b)(1) or (b)(3) occurred.

ERISA Opinion Letter 2005-10A issued 05/11/2005.

Synopsis. A fiduciary of an IRA who exercises authority over the assets of the IRA by providing investment advice to the IRA holder, where the advice, if followed, would result in the receipt by the fiduciary of advisory fees from mutual funds in which the IRA's assets were invested, does not engage in a prohibited transaction under Code Sections 4975(c)(1)(E) and (F), if it offsets the management fee it charges the IRA by the fees received from the mutual funds and if the fees paid to it by the mutual funds do not cause it to receive compensation in excess of the management fees the IRA holder has agreed to pay.

Facts. Country Trust Bank ("Bank") requested a prohibited transaction exemption from Code Section 4975(c)(1)(E) and (F) (the counterparts to ERISA Sections 406(b)(1) and (b)(3)) with regard to its receipt of fees from mutual funds in which its IRA clients had invested. The DOL determined there was no prohibited transaction under the facts disclosed, and instead issued an opinion letter. The Bank offered services to IRAs for which it served as trustee or

custodian. It provided investment advice to IRA holders amounting to recommending an investment strategy from among 5 model investment strategies it had developed following an analysis of the IRA holder's circumstances. The IRA holder retained final authority over whether to follow the Bank's investment advice. The model investment strategies invested in mutual funds, including some funds for which the Bank served as investment advisor ("affiliated funds"). The distributor for these affiliated funds is an unrelated third party; an affiliate of the Bank serves as broker-dealer for the affiliated funds pursuant to an agreement with the distributor of the funds, but none of the fees paid by the affiliated funds to the unrelated distributor would be used to compensate the broker-dealer for its services. The Bank receives advisory fees from the affiliated funds and management fees from each IRA. It is also entitled to receive non-advisory fees from the affiliated funds, including fees for custodial services and 12b-1 fees, but neither the Bank nor any affiliate of the Bank actually received those fees; however, if the Bank represented that if such fees were received they would be offset against the management fee paid by the IRAs. In addition, the IRA management fee is offset by any advisory fees the Bank receives as a result of the investment of the IRA's assets in the affiliated funds. Neither the Bank nor any affiliate of the Bank receives compensation from the unaffiliated funds that are included in the model investment strategies. Each affiliated fund pays the unrelated distributor 12b-1 fees, but the distributor does not use any portion of those fees to compensate Bank affiliates for investment in the affiliated funds. The DOL held that there was no prohibited transaction so long as the Bank offset its management fee by fees paid to it by the affiliated funds, <u>and so long as the fees paid to it by the affiliated funds did not cause its compensation to exceed the fees agreed to by the IRA holder</u>. The DOL noted that a similar analysis would apply to the extent the bank offered a similar program to retirement plans.

Individual Prohibited Transaction Exemption 98-25.

Facts. Olde Financial ("Financial" sponsored a 401(k) plan for its employees. It is a holding company with several subsidiaries, including Olde Discount ("Discount"). Financial provides recordkeeping and administrative services to the plan but does not charge a fee for its services. A committee comprised of employees selects the investment options available to plan participants from unrelated mutual funds. Discount is a broker that services the plan by purchasing mutual fund shares on its behalf and providing shareholder services to the plan. It receives no fees or commissions from the plan for those services. However, Discount receives 12b-1 fees from virtually all of the funds included as investment options under the plans. Olde requested an individual prohibited transaction exemption to cover its receipt of the 12b-1 fees, as well as for its proposed rebate of the fees to the plan or to the accounts of individual participants. The DOL granted the request for an IPTE, ruling that ERISA 406(a)(1)(B) and (D) and 406(b) would not be applied to Olde if specified conditions set forth in the IPTE were met. The conditions of the IPTE include the following (1) investment decisions are made by participants, (2) Olde is not

providing investment advice to participants, (3) no sales commissions other than 12b-1 fees are paid in connection with the purchase or sale of mutual fund shares, and no redemption fees are paid for the sale of shares, (4) Olde rebates the 12b-1 fees to the plan. In rebating the fees to the plan, Olde is required to credit to an account titled in the name of the plan the applicable 12b-1 fees, along with interest equal to the federal funds rate plus 2 percent (to make up for the amount of time it takes to determine the plan's share of the fees). The plan may then use amounts credited to the bank account to pay administrative expenses owed to third parties, but any amounts remaining in the account at the end of each calendar year must be allocated to participants. An independent auditor must audit the rebate program. In addition, Olde must provide participants with a number of disclosures, obtain acknowledgements and authorizations from participants, and retain records documenting its compliance with the conditions of the IPTE for a period of six years.