

# REVENUE SHARING ASPECTS OF QUALIFIED RETIREMENT PLAN MANAGEMENT

By Gregory W Kasten, MD, MBA, CFP, CPC  
President & CEO Unified Trust Company, NA

*Today, it's imperative that executives charged with fiduciary oversight of an organization's retirement or savings plan understand the distribution systems that investment management organizations use.*

Until a few years ago the market for retirement and savings plan services was uneventful. The plan trustee handled investment management. Typically plans were managed conservatively using low risk fixed income funding vehicles. Then, along came defined contribution plans, Code section 401, and a bit later, participant direction. Today things are much different!

In the mid 1990s too many service providers rushed to enter the lucrative 401(k) market. The supply side of the equation quickly reached a point well beyond saturation.



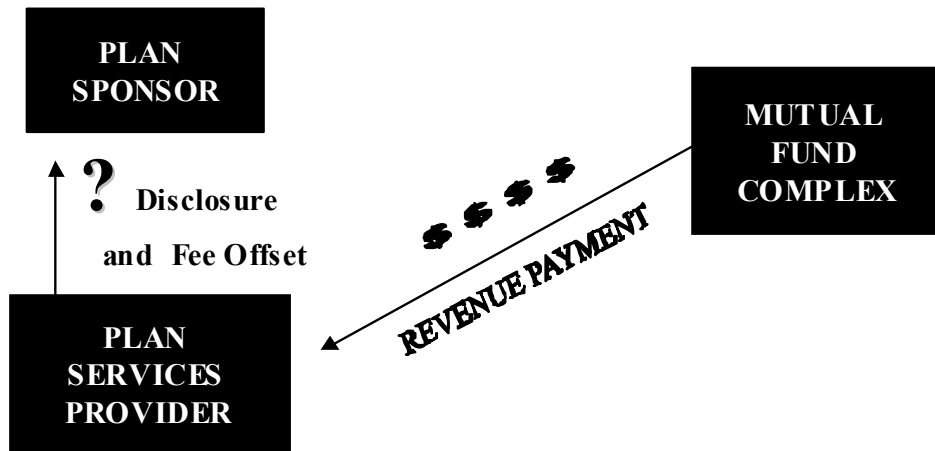
*“Now we have a current SEC investigation of mutual funds in 401(k) plans. The problem facing the industry is not with the SEC investigation of mutual fund complexes (a classic “Red Herring”), but rather it will be with the DOL and fiduciary breaches by the plan sponsor and plan service providers.*

*The mutual fund complexes for the most part followed the SEC rules and the underlying prospectus, but many service providers and plan sponsors violated ERISA fiduciary rules and DOL regulations.”*

Counting all share classes (A, B, C, D, I, R) there are more than 14,000 mutual funds available today (many more than the number of publicly traded stocks). In addition, as many as 250 vendor/product platforms (a platform is a bundled or integrated service encompassing administration, employee communications, advice and education, along with investment management) compete in the 401(k) market for the plan sponsor's attention and business. Many of these firms have adopted a “pay to play” business plan. Too many groups promote mutual funds and investments that pay them the most revenue. They do not disclose this revenue, and in some cases where they give advice, they do not offset this revenue dollar for dollar against their fees.

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# Mutual Fund Revenue Sharing Program



## SERVICE PROVIDER OVERSUPPLY

The investment management industry is undergoing consolidation. There may seem to be tremendous competition from a growing number of industry participants, but there are, in fact, fewer and fewer independent investment management organizations every day, but with an expanding array of products. Columbia Funds is now owned by Fleet Financial, which in turn was bought by Bank of America. Fidelity has more than 275 of its own funds. JP Morgan recently purchased Bank One.

The names often change, but the story remains the same. Consolidation means fewer firms, more brands, and a growing focus on investment management distribution through retirement plan products and service providers. This fierce competition for "shelf space" and mindshare of distribution systems for investment management products has resulted in revenue sharing and a "pay to play" mentality.

***"There is nothing inherently wrong with the mutual fund complexes making fully disclosed revenue payments. The problems arise when the payments are received by the service providers and not disclosed in all cases, and in some cases, offset dollar for dollar against billed fees."***

Today, more than ever before, it's critical that financial experts, human resources managers, and other executives/trustees charged with fiduciary oversight of an organization's qualified retirement or savings plan understand the distribution systems that investment management organizations use. And since retirement and savings plans are widely recognized as the main savings vehicle for most households, companies that sponsor plans need to be aware of the effect of distribution and revenue sharing on a product or service provider in terms of pricing and flexibility.

## **INVESTMENT MANAGEMENT DISTRIBUTION**

Sponsors of qualified retirement and savings plans represent a very large market for investment product manufacturers and distributors. The more than 610,000 qualified retirement plans in the United States today, with associated assets of more than \$2.6 trillion, essentially serve to aggregate the long-term savings of nearly 65 million U.S. workers.

Distribution of investment product to retirement and savings plans can take many forms. In addition to direct distribution, these forms include distribution through various types of service providers:

- A mutual fund platform;
- A registered investment adviser;
- An insurance company platform;
- An insurance agent or broker channel;
- A broker/dealer platform;
- A registered representative or advisor channel;
- A bank product platform;
- A TPA alliance with a broker/dealer;
- A consultant.

Distribution systems consist of sales, marketing and customer service staff all of whom must be compensated for providing sales, marketing and ancillary services. To furnish financial incentives and simply to pay for representation by such distributors, investment management firms have devised a range of methods to facilitate payment to the distributors of their products.

A further complication that readers need to recognize is the blurring of lines between investment product manufacturers and distributors. Merrill Lynch, Fidelity, U.S. Bank, Charles Schwab, and Aetna, to name just five, all have their own investment management products and offer distribution services to other investment management firms. This practice is becoming common as the trend of merger, acquisition, and consolidation continues.

There are two important rules of thumb for plan sponsors:

- There's no such thing as a free lunch. More investment flexibility generally means larger expenses as a distributor fee is added.
- Distributors must be compensated. The distributing entity for your plan and investments will likely receive some form of remuneration from the investment management products that it represents.

## **REVENUE SHARING DEFINED**

Revenue sharing is the allowance of payment of some portion of the internal fees associated with an investment product to a group providing services to the plan sponsor. Historically such allowance may or may not be known to a plan sponsor. Revenue sharing provides a practical and useful way to compensate for qualified retirement plan management, and helps ensure that appropriate fees are paid to the individuals and firms providing services to a plan, but it must be fully disclosed and in some cases offset dollar for dollars against the service provider's billed fees.

## **12(B)1 FEES**

Revenue sharing can take many forms. A common means of revenue sharing in the mutual fund industry is the use of 12(b)1 fees. 12(b)1 fees have long been a part of the industry, and traditionally have been included as part of a mutual fund's expense associated with marketing and distribution. This fee, if charged, is deducted from fund assets to compensate sales professionals for providing investment advice and ongoing services to mutual fund shareholders and to pay fund marketing and advertising expenses.

Rule 12b-1 of the U.S. Securities and Exchange Commission allows a mutual fund, under specified circumstances, to use fund assets to pay for distribution expenses. The size of the annual 12b-1 fee can vary from 0.05% of assets to 1.00% of assets. Since the adoption of the rule in 1980, mutual funds have used 12b-1 fees, often in combination with contingent-deferred sales charges, as an alternative to front-end sales loads for compensating sales professionals for assistance provided to purchasers of fund shares.

Other uses of 12b-1 fees have included advertising, sales materials, and activities involving the marketing of fund shares to new investors. Finally, mutual funds have used 12b-1 fees to pay for administrative services provided by third parties to existing fund shareholders. According to recent industry surveys, covering the costs of compensating broker-dealers for the sale of fund shares and related expenses is the most important use of 12b-1 fees. Expenses related to this type of distribution activity accounted for 63% of 12b-1 fees.

## **SHAREHOLDER SERVICING FEES**

These expenses include, for example, fees paid to a fund's transfer agent or other groups for providing fund shareholder services, such as toll-free phone communications, help centers, computerized account services, Web site services, recordkeeping, printing, and mailing. In many cases the shareholder servicing fee is equal to or larger than the 12b-1 fee. Many funds show up in mutual fund databases as "not paying a 12b-1 fees", but instead pay a shareholder servicing fee.

## **SUB-TRANSFER AGENCY FEES**

These fees represent a portion of the compensation normally paid to fund transfer agents diverted to those performing shareholder recordkeeping, recording daily activity and handling all shareholder servicing, from issuing account statements, confirmations, and tax statements to maintaining customer service departments on behalf of the funds. Most of these duties fall to the plan's administration provider in a participant-directed, defined contribution plan, and the administrator can be compensated for taking over this function if arrangements are made and contracts negotiated. Such revenues take the form of asset-based fees, fixed fees on a per-participant basis, or a combination of both.

When paid as a per-participant fee, payment formulas for subtransfer agent fees have a broad range. Annual compensation varies from \$3 per participant position (owning shares in a fund) in a given fund family to as much as \$23 per position. Some funds compensate for all positions; others cap at, say, three positions within the family for any given participant. Hybrid approaches, intended to reduce exposure to adverse selection, have formulas that pay, for example, \$10 per position capped at 10 basis points (0.10%) on total plan assets. Some families pay higher amounts, if the plan participant's personal information is shared by the record-keeper.

## FINDERS FEES

Some mutual fund groups will pay a one-time finders fee for the placement of the money. Finders fees represent a very attractive revenue sharing vehicle for the plan sponsor and plan participants, since they are entirely paid for by the mutual fund group. In addition, new contributions to the fund also qualify for the finders fee. The mutual fund may pay a 1.00% finders fee, and yet have an annual expense ratio below 0.75%. Finders' fees create opportunities for plan sponsors to reduce expenses without reducing services or to increase services without increasing fees. Many plans operate with the finders fees secretly retained by the investment provider, but Unified provides full disclosure of the finders fees and the services provided. This is consistent with the Frost National Bank DOL letter.

## COLLECTIVE INVESTMENT FUND REVENUE SHARING FEES

The final form of revenue sharing is a Collective Investment Fund revenue sharing fee. Such fees are very similar to the mutual fund 12(b)1 fees. 12(b)1 fees have long been a part of the industry, and traditionally have been included as part of a mutual fund's expenses associated with marketing and distribution. The revenue sharing fee of the Collective Investment Fund is a very attractive 0.75% annual fee. The Collective Investment Fund annual 0.75% revenue sharing fee dwarfs the traditional mutual fund 0.25% 12(b)1 fee.

## A REVIEW OF THE RULES

**ERISA Section 404(a)(1)(a):** The Exclusive Benefit Rule. Fiduciaries must act in the exclusive interests of plan participants and beneficiaries. In other words, fiduciaries may not even consider the size of their own compensation in making investment decisions for the plan; they may consider only what is best for participants.

**ERISA Section 406(b):** A broad prohibition against fiduciary self-dealing in a variety of forms. In the case of revenue sharing, fiduciaries are prohibited from receiving compensation of any sort that might influence the decision-making process. As a .50% payment by Fund A might influence a fiduciary to choose Fund A over Fund B, which only pays .25%, the receipt of such payments is a prohibited transaction. Overall, fiduciaries may not "receive any consideration from any party dealing with a plan in connection with a transaction involving plan assets," although specific exemptions exist.

**DOL Advisory Opinion 1997-15A:** The Frost Letter. In the Frost Letter, the DOL clarifies that a fiduciary with control over the investment selection for a plan may collect revenue-sharing payments on behalf of the plan *but must account for each payment and pass it on 100% to the plan in the form of an expense offset or direct payment.*

The problem with the Frost Letter is that it goes further; it suggests that even an ERISA investment advisor or other fiduciary who does not have discretion is also bound by the prohibition against keeping the revenue-sharing payments. Thus, a directed trustee, or a fiduciary with no discretion over plan assets, or not giving advice about which funds to select for the plan, could be prohibited from accepting revenue-sharing payments, contrary to the existing practice of many directed trustees and other vendors. This concern led ABN/AMRO to seek clarification, which the DOL provided in 2003-09A.

**DOL Advisory Opinion 1997-16A:** The Aetna Letter. In the Aetna letter, the DOL clarifies that a nondiscretionary nonfiduciary can keep revenue-sharing payments. More importantly, however, the Aetna Letter provides a crucial insight: that plan fiduciaries have an obligation to discover the full amounts of compensation from whatever source derived, including revenue-sharing payments. In other words, the DOL believes that plan fiduciaries are expected to discover the existence and amounts of revenue-sharing payments to all vendors. Considering that the available disclosure is limited, proper discovery can be quite difficult.

**DOL Advisory Opinion 2003-09A:** The ABN AMRO Letter. Here the DOL solved the problem created by the language in the Frost Letter by clarifying that a directed trustee with no discretion over plan assets, and not giving “investment advice” as defined by regulation, could keep revenue sharing payments. Thus, those vendors who offer “co-fiduciary” services under various labels but do not accept true discretion over plan assets-or give investment advice-avoid the problem of not being permitted to continue accepting revenue sharing payments.

Since most plan platforms are predicated on such payments, a different ruling from DOL would have had immediate and far-reaching consequences for the industry. In the ABN AMRO case, ABN AMRO serves as plan trustee but as directed trustee, not discretionary, and even though a trustee is always a fiduciary—which would seem to require conformance with the Frost Letter—this ruling agreed with ABN AMRO that it could keep the revenue sharing payments.

Over the last several years, several significant cases have been brought claiming breaches of fiduciary responsibility based upon 401(k) plan investment-fund selection, in some cases related to retail (through a broker) versus institutional (without broker involvement) fund use. In one such case, a substantial amount was paid (more than \$25 million) as part of a negotiated settlement. Others are still pending. Though three or four high-visibility court cases do not represent a tidal wave of litigation, some observers suggest that in the current environment, more may be expected, which may affect the decisions of other retirement plan fiduciaries.

*“Finally, it should be noted that ERISA's general standards of fiduciary conduct also would apply to ALL of the revenue sharing arrangements. Under section 404(a)(1) of ERISA, the responsible Plan fiduciaries must act prudently and solely in the interest of the Plan participants and beneficiaries both in deciding whether to enter into, or continue revenue sharing arrangements with service providers, and in determining which investment options to utilize or make available to Plan participants and beneficiaries.*

*In this regard, the responsible Plan fiduciaries must assure that the compensation paid directly or indirectly by the Plan is reasonable, taking into account the services provided to the Plan as well as any other fees or compensation received by third parties in connection with the investment of Plan assets.*

*The responsible Plan fiduciaries therefore must obtain sufficient information regarding any fees or other compensation that any service provider receives with respect to the Plan's investments in each mutual fund to make an informed decision whether such compensation for services is no more than reasonable.”*

**THE FROST MODEL:  
“AN ACID TEST OF FIDUCIARY STATUS”**

The DOL “Frost” model, in which vendors fully disclose and then pass through 100% of all revenue sharing payments, is in many ways an acid test of fiduciary status. Vendors that offer to serve as a “plan fiduciary” but keep hidden revenue sharing payments either are not accepting discretion—and therefore liability—or operate in direct violation of the Frost Letter.

Service providers that are offering some type of co-fiduciary limited advice but not following the Frost Model expose the plan sponsor to significant fiduciary risk, since under all three DOL opinions described above (97-15, 97-16 and 2003-09) the plan sponsor has a fiduciary duty to know the facts and make a prudent decision for the exclusive benefit of plan participants.

Vendors that accept full discretion and fiduciary status over plan assets, on the other hand, are bound by the Frost Letter and are generally liable in the plan sponsor’s place for prudent management of plan assets—at least to the extent specified in the vendor’s contract or trust agreement.

Why is this “test” useful? Because most plan sponsors do not understand the distinction between directed and discretionary, or between a co-fiduciary responsible for only a small part of the plan and a co-fiduciary with full responsibility for plan assets. It might therefore be unclear to sponsors that vendors offering to serve in a fiduciary capacity come in all shapes and sizes, and that some accept more responsibility and liability than others. The only way to be certain of the true extent of a vendor’s responsibilities is to study the trust or service agreement, but noncompliance with the Frost model is a simple, useful indicator.

We have seen many instances where plan sponsors can misperceive the extent of a vendor’s fiduciary responsibility. For example, recently a vendor was offering to serve as “plan fiduciary,” a feature that the director of human resources found very appealing. The vendor was offering a passive, directed-trustee service—custodial only—yet the plan sponsor clearly was under the impression that the vendor was accepting full liability for the plan.

As the vendor followed the Aetna model, not the Frost model, with respect to revenue-sharing payments, it was not difficult to set the client straight. The vendor was actually offering only a passive, directed trustee service—custodial only—yet the plan sponsor clearly was under the impression that the vendor was accepting full liability for the plan. Since the vendor followed the Aetna model, not the Frost model, with respect to revenue sharing payments, it was not difficult to set the client straight.

Given the level of regulatory interest in these practices, however, it seems likely that more and more vendors in the future will adopt the Frost model regardless of their fiduciary status. It is even possible that SEC and DOL will create new rules that make the Frost model the de facto standard.

Thus, while it might be true that a vendor failing to use Frost as its revenue sharing model cannot be properly discretionary, the reverse is not true: a non-fiduciary vendor could certainly adopt Frost without accepting any fiduciary responsibility or liability. We hope the entire industry moves in this direction.

## **MANAGING AND AUDITING THE PROCESS**

Tracking the various revenue sharing components can be an arduous task. Unified Trust has created a revenue sharing accounting system to track all aspects of this process. Each step must be measured and verified. For example, every revenue payment source due from each mutual fund is calculated by Unified. Our experience has shown that many fund groups incorrectly calculate the fee and remit an incorrect payment. Once each piece of revenue share is calculated and properly accounted for, Unified credits the fee to the plan. The plan sponsor receives regular detailed reporting illustrating all sources of revenue share and credits to the plan. (Sample on next page 9)

### **UNIFIED ERISA REVENUE TRACKER<sup>SM</sup> SOFTWARE**

1. Calculates the exact revenue share the plan should receive (about 30% of the time the payment is incorrect by the mutual fund company--usually too low!)
2. Reconciles the payment back to each plan.
3. Produces a statement for the plan sponsor every quarter showing all sources of revenue credits for their plan.
4. Offsets the Unified Trust fee dollar for dollar against the revenue share and credits all revenue back to the plan.
5. In cases where there is more revenue share than fees, the plan is paid a net dividend.

## **GATHERING THE DETAILS**

The first step in reaping the potential benefits from revenue sharing is for the plan sponsor find out how this element may apply to their retirement and savings plans either currently or potentially. The plan sponsor's job is to understand and document the full details of the fees their plan pays, including all investment management fees and other asset-based fees. This is the case whether the plan uses mutual funds, collective trust instruments, separate investment management accounts, brokerage accounts, an insurance contract, or any other form of funding instrument.

## **BENEFITING FROM REVENUE SHARING**

The practice of revenue sharing in the retirement and investment management businesses is here to stay. As a sponsor, retirement committee member, director, or HR manager of a qualified retirement or savings plan, your job is to be completely aware of all fees related to the operation of your plan.

Require complete disclosure from all plan service providers. Require a disclosure letter for your files, signed by each investment management firm and service provider, attesting to each one's fee amount and form of compensation, including any portion of that fee paid to another party. Require a disclosure of potential conflict from each service provider. This will help to identify any parties who may be receiving or providing revenue sharing in any other form.

In addition, you should audit for the presence of revenue sharing. Read the fine print in every prospectus, with an eye toward expense items. You should identify all services provided to your plan by any firm or individual. Measure the amount of fees each service provider receives from all sources involved in your plan. You are now in a position to evaluate each service provided to your plan in the context of economic benefit received for those services. There may be no misalignment. Or there may be opportunities to reduce costs or identify capacity for additional services with no added expenses to your plan so that the participants' odds of retirement success are improved.

**UNIFIED TRUST COMPANY  
REVENUE SHARING INVOICE**



2353 Alexandria Drive · Suite 100 ·  
Lexington, KY 40504

XYZ CLIENT  
MAIN STREET  
ANYWHERE, USA

Account Number: 000125677  
Invoice Number: 1733  
Invoice Date: July 02, 2003

Average Daily Balance    \$1,406,616.06

**Fees**

Recordkeeping Fee                    \$250.00  
Discretionary Trustee Fee            \$1,878.11

**Total Fees                                \$2,128.11**

**Revenue Credits**

12b-1 Revenue                        \$(307.74)  
Shareholder Serving Fees            \$(1,218.96)

**Total Revenue                         \$(1,526.70)**

**Amount Due This Quarter:        \$601.41**

Under the DOL Frost Letter, Unified Trust Company, N.A., offsets your fees with any revenue credits from the underlying investments. You may pay any net amount due directly. If not paid directly, any remaining amount due will be deducted from plan assets as described in your Plan Services Agreement.

# PWBA Office of Regulations and Interpretations

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## Advisory Opinion

May 22, 1997

97-15A  
ERISA SEC.  
406(b)(3)

Mark S. Miller  
Fulbright & Jaworski, LLP  
1301 McKinney, Suite 5100  
Houston, Texas 77010-3095

Dear Mr. Miller:

This is in response to your request for an advisory opinion regarding the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (ERISA). In particular, you ask whether the payment of certain fees by a mutual fund in which an employee pension benefit plan has invested to a bank serving as the plan's trustee would violate sections 406(b)(1) and 406(b)(3) of ERISA.

You represent that Frost National Bank (Frost) serves as trustee to various employee pension benefit plans (the Plans). As trustee of the Plans, Frost's duties may include one or more of the following functions, pursuant to instructions from the Plan sponsor or participants: opening and maintaining individual participant accounts; receiving contributions from the Plan sponsor and crediting them to individual participant accounts; investing contributions in shares of a mutual fund and reinvesting dividends and other distributions; redeeming, transferring, or exchanging mutual fund shares; providing or maintaining various administrative forms in making distributions from the Plan to participants or beneficiaries; keeping custody of the Plan's assets; withholding amounts on Plan distributions; making sure all Plan loan payments are collected and properly credited; conducting Plan enrollment meetings; and preparing newsletters and videos relating to the administration of the Plan.

In connection with its Plan-related business, Frost has entered into arrangements with one or more distributors of, or investment advisors to, mutual fund families pursuant to which Frost will make the mutual fund families available for investment by the Plans. Frost will periodically review each such mutual fund family to determine whether to continue the arrangement, and will reserve the right to add or remove mutual fund families that it makes available to the Plans.

As part of Frost's arrangements with the mutual fund families, Frost may provide shareholder services to, and receive fees from, some of the individual mutual funds in which Plan assets are invested. The shareholder services may include, e.g., providing mutual fund recordkeeping and accounting services in connection with the Plans' purchase or sale of shares, processing mutual fund

sales and redemption transactions involving the Plans, and providing mutual fund enrollment material (including prospectuses) to Plan participants. The fees paid by the mutual funds to Frost will generally be based on a percentage of Plan assets invested in each mutual fund, and will be paid pursuant to either a distribution plan described in Securities and Exchange Commission (SEC) Rule 12b-1, 17 C.F.R. 270.12b-1 (a 12b-1 plan), or a "subtransfer agency arrangement."<sup>1</sup>

You further represent that, with respect to some of the Plans, Frost will recommend to the Plan fiduciary the advisability of investing in particular mutual funds offered pursuant to Frost's arrangements with the mutual fund families. In addition, Frost will monitor the performance of the individual mutual funds selected by the Plan fiduciary and, as it deems appropriate, will make further recommendations regarding additional or substitute mutual funds for the investment of Plan assets.

With respect to other Plans, Frost will not make any recommendations concerning the selection of, or continued investment in, particular mutual funds. Rather, the responsible Plan fiduciary will independently select, from the mutual fund families made available by Frost, particular mutual funds for the investment of Plan assets, or for designation as investment alternatives offered to participants under the Plan.

In both instances, whether or not Frost makes specific investment recommendations, you represent that, before a Plan enters into the arrangement, the terms of Frost's fee arrangements with the mutual fund families will be fully disclosed to the Plans. In addition, Frost's trustee agreement with a Plan will be structured so that any 12b-1 or subtransfer agent fees received by Frost that are attributable to the Plan's investment in a mutual fund will be used to benefit the Plan. Pursuant to the particular agreement with each Plan, Frost will offset such fees, on a dollar-for-dollar basis, against the trustee fee that the Plan is obligated to pay Frost or against the recordkeeping fee that the Plan is obligated to pay to a third-party recordkeeper; or Frost will credit the Plan directly with the fees it receives based on the investment of Plan assets in the mutual fund.<sup>2</sup> The trustee agreement will provide that, to the extent that Frost receives fees from mutual funds in connection with the Plan's investments that are in excess of the fee that the Plan owes to Frost, the Plan will be entitled to the excess amount.

You request an opinion that Frost's receipt of fees from the mutual funds under the circumstances described would not constitute a violation of ERISA section 406(b)(1) or (b)(3).<sup>3</sup> You have asked us to assume for the purpose of your request that the arrangements between Frost and the Plans satisfy the conditions of ERISA section 408(b)(2).<sup>4</sup>

Section 406(b)(1) of ERISA prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in his or her own interest or for his or her own account. Section 406(b)(3) prohibits a fiduciary with respect to a plan from receiving any consideration for his or her personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.<sup>5</sup>

Under section 3(21)(A) of ERISA, a person is a "fiduciary" with respect to a plan to the extent that the person (i) exercises any discretionary authority or control respecting management of the plan or any authority or control respecting management or disposition of its assets, (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so, or (iii) has any discretionary authority or responsibility in the administration of the plan.

Frost, as trustee, is a fiduciary with respect to the Plans under section 3(21)(A) of ERISA. [See 29 C.F.R. 2509.75-8, D-3](#) (the position of trustee of a plan, by its very nature, requires the person who holds it to perform one or more of the functions described in ERISA section 3(21)(A)).<sup>6</sup>

### **When the Trustee Advises**

You have indicated that, with respect to some of the Plans, Frost will advise the Plan fiduciary regarding particular mutual funds in which to invest Plan assets.<sup>7</sup> It also appears from your submission that, under Frost's arrangements with various mutual fund families, Frost may receive fees from some of the mutual funds as a result of a Plan's investment in the mutual funds recommended by Frost. In the view of the Department, advising that plan assets be invested in mutual funds that pay additional fees to the advising fiduciary generally would violate the prohibitions of ERISA section 406(b)(1).

You represent, however, that before entering into an arrangement with a Plan, or recommending any particular mutual fund investments, Frost will disclose to the Plan fiduciary the extent to which it may receive fees from the mutual fund(s). Furthermore, you represent that the trustee agreement between Frost and the Plan will expressly provide that any fees received by Frost as a result of the Plan's investment in such a mutual fund will be used to pay all or a portion of the compensation that the Plan is obligated to pay to Frost, and that the Plan will be entitled to any such fees that exceed the Plan's liability to Frost.<sup>8</sup> To the extent the Plan's legal obligation to Frost is extinguished by the amount of the offset, it is the opinion of the Department that Frost would not be dealing with the assets of the Plan in its own interest or for its own account in violation of section 406(b)(1).

With respect to the prohibition of section 406(b)(3), Frost's contract with a Plan, as described above, will provide that Frost's receipt of fees from one or more mutual funds in connection with the Plan's investment in such funds will be used to reduce the Plan's obligation to Frost, will in no circumstances increase Frost's compensation, and thus will benefit the Plan rather than Frost. Accordingly, it is the opinion of the Department that in these circumstances Frost would not be deemed to receive such payments for its own personal account in violation of section 406(b)(3).

### **When the Trustee is Directed**

With respect to Plans for which Frost does not provide any investment advice, it appears that the Plan fiduciary, and in some instances the Plan participants, will select the mutual funds in which to invest Plan assets from among those made available by Frost. Generally speaking, if a trustee acts pursuant to a direction in accordance with section 403(a)(1) or 404(c) of ERISA and does not exercise any authority or control to cause a plan to invest in a mutual fund that pays a fee to the trustee in connection with the plan's investment, the trustee would not be dealing with the assets of the plan for its own interest or for its own account in violation of section 406(b)(1).

Similarly, it is generally the view of the Department that if a trustee acts pursuant to a direction in accordance with section 403(a)(1) or 404(c) of ERISA and does not exercise any authority or control to cause a plan to invest in a mutual fund, the mere receipt by the trustee of a fee or other compensation from the mutual fund in connection with such investment would not in and of itself violate section 406(b)(3). Your submission indicates, however, that Frost reserves the right to add or remove mutual fund families that it makes available to Plans. Under these circumstances, we are unable to conclude that Frost would not exercise any discretionary authority or control to cause the Plans to invest in mutual funds that pay a fee or other compensation to Frost.<sup>9</sup>

However, because Frost's trustee agreements with the Plans are structured so that any 12b-1 or subtransfer agent fees attributable to the Plans' investments in mutual funds are used to benefit the

Plans, either as a dollar-for-dollar offset against the fees the Plans would be obligated to pay to Frost for its services or as amounts credited directly to the Plans, it is the view of the Department that Frost would not be dealing with the assets of the Plans in its own interest or for its own account, or receiving payments for its own personal account in violation of section 406(b)(1) or (b)(3).

Finally, it should be noted that ERISA's general standards of fiduciary conduct also would apply to the proposed arrangement. Under section 404(a)(1) of ERISA, the responsible Plan fiduciaries must act prudently and solely in the interest of the Plan participants and beneficiaries both in deciding whether to enter into, or continue, the above-described arrangement and trustee agreement with Frost, and in determining which investment options to utilize or make available to Plan participants or beneficiaries. In this regard, the responsible Plan fiduciaries must assure that the compensation paid directly or indirectly by the Plan to Frost is reasonable, taking into account the trustee services provided to the Plan as well as any other fees or compensation received by Frost in connection with the investment of Plan assets. In this connection, it is the view of the Department that the responsible Plan fiduciaries must obtain sufficient information regarding any fees or other compensation that Frost receives with respect to the Plan's investments in each mutual fund to make an informed decision whether Frost's compensation for services is no more than reasonable. The Plan fiduciaries also must periodically monitor the actions taken by Frost in the performance of its duties, to assure, among other things, that any fee offsets to which the Plan is entitled are correctly calculated and applied.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, August 27, 1976). Accordingly, it is issued subject to the provisions of that procedure, including section 10 thereof regarding the effect of advisory opinions.

Sincerely,  
Bette J. Briggs  
Chief, Division of

Fiduciary

Interpretations  
Office of Regulations

and

Interpretations

<sup>1</sup> A "subtransfer agency fee" is typically a fee paid for recordkeeping services provided to the mutual fund transfer agent with respect to bank customers.

<sup>2</sup> We assume for purposes of this opinion that each Plan's governing documents provide that the Plan will pay costs and expenses for trustee services necessary to the operation and administration of the Plan.

<sup>3</sup> For a discussion of related issues involving receipt of fees by a record-keeper offering a program of investment options and services to plans, see also [Advisory Opinion 97-16A](#), May 22, 1997.

<sup>4</sup> We offer no opinion herein as to whether such conditions have been satisfied; nor does this opinion address the application of any other provisions of ERISA.

<sup>5</sup> Under Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Internal Revenue Code of 1986 (the Code) has been transferred, with certain exceptions not here relevant, to the Secretary of Labor, and the Secretary of the Treasury is bound by interpretations of the Secretary of

Labor pursuant to such authority. Therefore, references in this letter to specific sections of ERISA should be read to refer also to the corresponding sections of the Code.

<sup>6</sup> Section 403(a) of ERISA establishes that, in general, a trustee of a plan must have exclusive authority and discretion to manage and control the plan's assets. Under section 403(a)(1), when the plan expressly so provides, the trustee may be subject to the proper directions of a named fiduciary which are made in accordance with the terms of the plan and not contrary to ERISA. Nevertheless, a directed trustee has residual fiduciary responsibility for determining whether a given direction is proper and whether following the direction would result in a violation of ERISA. Accordingly, it is the view of the Department that a directed trustee necessarily will perform fiduciary functions.

<sup>7</sup> We assume for the purposes of your request that Frost will provide investment advice within the meaning of ERISA section 3(21)(A)(ii) and 29 C.F.R. 2510.3-21(c)(1)(i) and (ii)(B) with respect to these Plans.

<sup>8</sup> We express no opinion herein as to the propriety of such a pass-through of fees under Federal securities laws. Questions concerning the application of the Federal securities laws are within the jurisdiction of the SEC.

<sup>9</sup> See, in this regard, the Department's position as expressed in the preamble to the final regulation regarding participant-directed individual account plans (ERISA section 404(c) plans), 57 Fed. Reg. 46906, 46924 n. 27 (Oct. 13, 1992):

In this regard a fiduciary is relieved of responsibility only for the direct and necessary consequences of a participant's exercise of control], the Department points out that the act of limiting or designating investment options which are intended to constitute all or part of the investment universe of an ERISA 404(c) plan is a fiduciary function which, whether achieved through fiduciary designation or express plan language, is not a direct or necessary result of any participant direction of such plan.

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