Executive summary

• Plan sponsors have always had an obligation to understand the nature and amount of fees paid for retirement plan services and to ensure that those fees are reasonable. But in recent years, litigation and regulation have prompted many plan sponsors to revisit the cost and payment mechanism for retirement plan service fees.

• In the past, defined contribution (DC) plan sponsors and service providers typically treated revenue generated from the plan’s assets as the primary method of payment for recordkeeping service fees. This recordkeeping revenue has grown over the years due to regular employer and employee contributions and market appreciation of plan assets.

• Plan sponsors and recordkeepers have worked together to ensure that the revenue-sharing amount received by the recordkeeper doesn’t exceed the amount specified for the price of administrative services. This can be accomplished through a variety of arrangements, such as adopting lower-priced share classes (with a corresponding reduction in credits or revenue sharing for recordkeeping) or transitioning from asset-based fees to flat, per-participant fees.

• Elimination of asset-based fees, though, may not always be desired—or even possible. ERISA budget accounts have emerged as an additional solution to manage excessive recordkeeping fees. We refer to an ERISA budget account as an unallocated account held within the plan that is funded by some or all of the asset-based fee revenue received by a service provider. While this type of arrangement can be a useful tool, there are many important issues to consider.

• This commentary discusses the historical practice of paying plan expenses from revenue sharing and the fiduciary and administrative considerations of using an ERISA budget account for managing recordkeeping revenue.
**Background**

To comply with ERISA’s prohibited transaction rules, plan sponsors must ensure that only reasonable plan service fees are paid from retirement plan assets. This requirement was bolstered in 2012 when the Department of Labor (DOL) issued new final regulations mandating the disclosure of compensation by entities providing services to ERISA-governed retirement plans.

These disclosures help plan sponsors better understand how fees are paid. Plan sponsors now place greater scrutiny on fees paid for investments, especially when the investment fees include a revenue-sharing component. In the context of retirement plans, revenue sharing occurs when an investment fund or fund company pays a portion of its expense ratio to a recordkeeper for the administration, distribution, marketing, or accounting costs related to holding the fund on the recordkeeper’s platform.¹

In a typical plan investment menu containing a mix of actively and passively managed funds, revenue-sharing amounts may vary across funds.²

Frequently, plan sponsors and recordkeepers decide to use revenue sharing as the sole method of payment for recordkeeping expenses. During years of declining market performance or significant withdrawals, the recordkeeper may earn less in compensation than during years of market appreciation and continued plan contributions.

Increasing market volatility, especially during and after the financial crisis in 2008, has made it difficult for plan sponsors to ensure that recordkeepers being paid through revenue sharing receive reasonable compensation. If the revenue sharing fails to reach the amount expected by the recordkeeper, the recordkeeper bears the risk. In such cases, the parties may agree to an additional fee (e.g., an additional flat per-participant fee or a gross amount paid by the plan sponsor) to cover the specified cost for recordkeeping services.

Additionally, plan sponsors have begun to seek alternative approaches for managing recordkeeping revenue when the amount received by the recordkeeper exceeds the amount expected, including the ERISA budget account.

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¹ Under most revenue-sharing arrangements, a portion of an investment’s expense ratio will be designated as the revenue-sharing amount to be paid to the recordkeeper pursuant to an agreement between the fund company and the recordkeeper. For example, a “retail” share class of an actively managed equity mutual fund might have an expense ratio of 65 basis points including revenue sharing of 15 basis points. This means that the fees paid to the fund company for investment in the fund equal 0.65% of invested assets, of which 0.15% is then paid to the recordkeeper as revenue sharing. Put another way, for every $1,000 invested by participants in the fund, the fund company collects $6.50, of which $1.50 is then paid to the recordkeeper as revenue sharing.

² It should be noted that Vanguard mutual funds and collective trusts don’t pay revenue sharing to retirement plan recordkeepers. To the extent that Vanguard provides recordkeeping services to a retirement plan, the retirement plan may receive a “recordkeeping credit” for certain share classes of Vanguard mutual funds or certain Vanguard collective trusts. This credit offsets other recordkeeping fees that would be charged to the plan.
What is an ERISA budget account?

Known by many names, an ERISA budget account can be used to track the plan’s recapture and use of revenue sharing. It may be created when the plan’s recordkeeper agrees to return to the plan a portion of the revenue sharing received from a fund or fund company. Typically, plan sponsors establish these accounts within the plan’s trust to help manage their fiduciary responsibilities. Amounts held in the account frequently will be used to pay for plan services, but in some instances, such amounts will be allocated back to plan participants.

Only expenses deemed reasonable and necessary for plan administration by the plan sponsor may be paid from an ERISA budget account. Common expenses paid from such an account include plan audit charges, annual valuation services, legal and consulting services related to plan administration, participant notices, education, mailing costs, and nondiscrimination testing.

While ERISA budget accounts have been around for many years and are growing in popularity, the rules for ERISA accounts aren’t entirely clear. The DOL hasn’t remained completely silent on the topic; supplemental FAQs issued in 2009 address ERISA budget accounts and the reporting of service provider compensation on Schedule C of Form 5500. However, DOL’s relative lack of guidance, when compared with other emerging fiduciary topics, comes as a surprise and should be factored in when considering an ERISA budget account.

Plan sponsor approach to payment of fees

To determine whether an ERISA budget account arrangement makes sense, plan fiduciaries must assess the plan’s investment lineup, revenue sharing received from plan investments, recordkeeping fee arrangement, and available options for reducing or eliminating excess revenue.

Plan sponsors need to make two decisions: Should investments with revenue sharing be included in the plan? How will fees be allocated among participants? While both are independent fiduciary choices, they have been historically linked because revenue sharing from investments has been used to cover recordkeeping costs.

The DOL permits great flexibility in fee allocation methods. The 2012 commentary, Slicing and dicing retirement plan fees: Allocation considerations for plan sponsors, provides an in-depth discussion about various fee allocation philosophies. Some of these methods include the pro-rata approach, where fees are based on the size of a participant’s account; the per-capita approach, where each participant pays the same amount regardless of account size; and a hybrid approach that combines asset-based fees with a per-participant charge.

The pro-rata approach has been popular for many years, in part thanks to the availability of revenue-sharing arrangements. The per-capita approach has been gaining traction in recent years as plan sponsors and service providers seek stability in recordkeeping fees by eliminating fee fluctuations attributable to market volatility.

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3 Other names that have been used for these arrangements include: ERISA recapture accounts, revenue-sharing accounts, ERISA expense accounts, plan revenue accounts (e.g., Vanguard Plan Revenue Account). This paper will refer to these types of funded, in-plan arrangements as ERISA budget accounts. For more information about a Vanguard Plan Revenue Account, contact your Vanguard plan representative.

4 An alternative to holding an ERISA budget account within a plan is the creation of a nominal account outside the plan in the books of the recordkeeper. When plan expenses are accrued, they are submitted to the recordkeeper for payment by the recordkeeper from its own assets. The nominal account is then reduced by the amount paid. The practical and fiduciary implications of these “outside the plan” arrangements are beyond the scope of this commentary.

5 In the FAQs, the DOL discusses whether amounts deposited by a recordkeeper into an “ERISA fee recapture account” are reportable as service provider compensation on the plan’s Schedule C. After concluding that the amount deposited into the ERISA fee recapture account doesn’t need to be reported on Schedule C, the DOL notes that “[n]ot everything in this answer should be read as expressing a view on when ERISA accounts and similar revenue-sharing arrangements may present prohibited transaction issues under ERISA.” More recently, the DOL again acknowledged the existence of ERISA budget accounts in Advisory Opinion 2013-03A. In that opinion, the DOL stated that, under the specific facts presented, revenue-sharing payments reflected in an “outside the plan” ERISA budget arrangement (like the arrangements described in footnote 3 above) generally don’t constitute plan assets.
In truth, however, the hybrid model may be the most viable for many plan sponsors. Many plans can’t go to a true per-capita formula for the payment of recordkeeping fees because the plan includes funds that only have share classes that include revenue sharing. As long as the recordkeeper receives revenue sharing, a portion of the plan’s recordkeeping fees is being paid on a pro-rata basis. The converse may also be true—a plan sponsor may seek to have all recordkeeping fees paid on a pro-rata basis, but the revenue sharing generated by plan investments may be insufficient to cover recordkeeping fees. In that case, the plan may charge an additional per-participant fee, with the combined revenue-sharing and per-participant fees adding up to the total recordkeeping charge.

Where revenue sharing exists, an ERISA budget account may be a useful tool to limit or manage the revenue sharing collected by the recordkeeper. In a plan where all fees are assessed on a pro-rata basis, the parties can determine that amounts received by the recordkeeper above a threshold amount should be deposited in the plan’s ERISA budget account. Moreover, for plan sponsors who seek a true per-capita approach but prefer to include funds in the plan that generate revenue sharing, the parties can agree to a flat per-participant recordkeeping charge, with all amounts received in revenue sharing deposited in the plan’s ERISA budget account.

While there isn’t one “right” method for allocating fees, recent court cases have emphasized the fiduciary responsibility to deliberate, analyze, and document the considerations and decisions made with respect to fee allocation.

**Fiduciary responsibilities**

Plan sponsors should thoroughly evaluate whether an ERISA budget account makes sense under their plan’s unique circumstances. An ERISA budget account may afford the plan sponsor a means to achieve stability in recordkeeping fees when revenue-sharing funds are included in the investment lineup. If the amount held in the ERISA budget account is large enough, it may also decrease the need to sweep participant accounts to pay periodic plan expenses such as audit fees, accounting fees, legal fees, and communication costs.

While ERISA budget accounts offer many benefits, they also come with risks. For instance, in recent years there has been a strong regulatory and plan sponsor focus on the disclosure and transparency of fees. An ERISA budget account may actually decrease transparency within a plan, since fees paid through the ERISA budget account generally don’t need to be individually disclosed to participants. Moreover, as discussed above, the DOL has issued little guidance explicitly addressing the holding of an ERISA budget account within a plan. If additional guidance is published to address this growing practice, plan sponsors will need to be vigilant and ensure that any ERISA budget accounts within their plans are in compliance.

Even in the absence of DOL guidance, plan sponsors must consider two sets of additional implications in connection with ERISA budget accounts. First, the plan sponsor must determine whether establishment and maintenance of an ERISA budget account within a plan is reasonable in light of other available alternatives. Then, assuming the ERISA budget account is a reasonable approach for a particular plan, the plan sponsor must ensure that its uses and administration comply with general expense payment, allocation, and depletion rules.
Reasonableness in light of available alternatives

In weighing the potential benefits and risks of an ERISA budget account, plan sponsors must be aware of potential alternatives that may better align the amounts collected for recordkeeping with the specified cost for recordkeeping services. An ERISA budget account may be used to recapture revenue-sharing payments in excess of the specified recordkeeping cost, but these alternative approaches may also be used to eliminate the “excess” and thereby mitigate the need for the ERISA budget account.

- **Move to a different share class.** To better align recordkeeping revenue with cost, it may be possible for the plan to transition investments to a share class that doesn’t produce revenue sharing or one that at least produces lower revenue sharing. Such a move, which would separate recordkeeping fees from investment fees, can increase fee transparency for participants and add cost certainty for plan sponsors.

- **Explore additional plan services.** In cases where a recordkeeper received revenue sharing beyond the agreed-upon charge for recordkeeping services, the parties could agree to add plan services (e.g., advice programs, participant education, nondiscrimination testing, etc.) that would benefit participants while also “using up” excess revenue sharing.

- **Provide rebates to participant plan accounts.** Rather than depositing revenue sharing into an ERISA budget account, a plan sponsor and recordkeeper may agree to rebate some or all of the revenue sharing directly to the participants invested in the fund that generated the revenue sharing.

In each of these cases, eliminating or reducing the revenue sharing, or managing it differently, mitigates the need for an ERISA budget account. Plan sponsors are well served to consult with their counsel and to understand the recordkeeper’s abilities in determining the best approach for the plan.
ERISA budget account administration

When an ERISA budget account is established as the conduit by which any excess recordkeeping revenue can be held for plan purposes, the plan fiduciaries must then decide how to use the account.

A useful framework is to think of the ERISA budget account as an unallocated account similar to forfeitures. The 2012 commentary, *Avoiding pitfalls in retirement plan forfeitures*, provides additional insight on the timing and approved uses of unallocated accounts. Fiduciaries must consider their responsibilities to determine how and when to use the ERISA budget account, as follows:

• **Approved use.** An ERISA budget account may be used to pay reasonable plan expenses. Common expenses include plan audits, annual valuation services, legal, and consulting services related to plan administration, participant notices, education and mailing costs, and nondiscrimination testing. The amounts held in the ERISA budget account must not be used for the benefit of the plan sponsor or for any expense that would be considered a “settlor” expense.⁶

• **Timely use.** An ERISA budget account should be used for the period to which it applies. Many plan sponsors use the ERISA budget account to pay reasonable plan expenses on an annual basis with any funds remaining at year-end allocated to participants. Alternatively, some plan sponsors determine that a rolling 12-month period is more appropriate. For any funds that will be allocated, fiduciaries must weigh the relevant factors in determining the appropriate method of allocation to affected participants (e.g., pro rata or per capita).

• **Investments.** Typically, unallocated accounts, like an ERISA budget account, are invested in a short-term reserve investment vehicle, such as a money market fund.

• **Documentation.** A best practice under ERISA is for the plan fiduciaries to create a well-documented record of their assessment of an ERISA budget account. It’s important to clearly identify the plan’s allocation method.

Considerations

An ERISA budget account is typically considered when “excess” recordkeeping revenue is generated in a significant and ongoing manner. In that situation, a plan sponsor may decide that an ERISA budget account can be a useful tool to handle the excess revenue. Be mindful, however, that the establishment and ongoing oversight of the account introduces additional fiduciary responsibility. In addition, there is minimal guidance from the DOL on these accounts. Alternatives are available to manage revenue sharing that may negate the need for an ERISA budget account. As always, it’s important for fiduciaries to understand the available options and determine the best method for the plan.

Adopting an ERISA budget account may not be necessary or appropriate for all plans. Plan sponsors should engage in a deliberative process that considers the plan’s approach and objectives regarding fees in order to reach a decision that serves the best interests of plan participants.

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⁶ Certain decisions made by a plan sponsor are made in its capacity as “settlor” or creator of the plan trust. Settlor decisions, such as whether to create a plan or how generous benefits should be under the plan, are decisions the employer must make as a matter of course in running its business and are separate from the operation, administration, or ongoing fiduciary oversight of the plan. Settlor expenses attributable to these settlor decisions may not be paid from plan assets.
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