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What the Tibble Decision Means to Advisers: Interesting Angles on the DOL's Fiduciary Rule #60

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Article By Drinker Biddle & Reath LLP
Fred ReishFredReish.com

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What the Tibble Decision Means to Advisers

This is my 60th article about interesting observations concerning the Department of Labor's fiduciary rule and exemptions. These articles also cover the DOL's FAQs interpreting the regulation and exemptions and related developments in the securities laws.

On June 9th, almost all advisers to retirement plans became fiduciaries—or, more accurately, those that were not already serving as fiduciary advisers became fiduciaries. While most of my Angles posts have been about the fiduciary rule and prohibited transaction exemptions, this article is about the impact of the latest Tibble decision (Tibble v. Edison Int'l, No. CV 07-5359 SVW (AGRx), 2017 WL 3523737 (C.D. Cal. Aug. 16, 2017)) on the development and delivery of fiduciary investment advice to 401(k) plans and ERISA-governed 403(b) plans.

As background, the Tibble case, through a series of decisions, held that it was a breach of fiduciary duty for a plan committee to select overly-expensive share classes of mutual funds. More specifically, the issue was whether the Tibble committee should have selected institutional share classes rather than retail share classes.

Viewed superficially, the decision could be interpreted to mean that plan fiduciaries must always select the cheapest share class. However, that is not correct. As a part of the decision, the attorneys for the plan committee argued that the retail share classes were justified since the revenue sharing paid by the mutual funds (and their affiliates) was used to pay for appropriate plan expenses (and, presumably, were enough to offset the additional cost of the retail share classes). The attorneys were justified in taking that position because other courts have held that, where mutual funds pay amounts to cover reasonable costs for operating a plan, the additional expense is reasonable. The Tibble court responded that the attorneys should have raised the argument at trial (which was years ago) and that the argument would not be considered at this point in the proceedings. As a result, the Tibble fiduciaries were left without a legal basis for justifying the increased expenses of the retail share classes.

With that background, plan committees, and their fiduciary advisers, have two alternatives when evaluating share classes. The first is to select the lowest-cost available share class, for example, an institutional share class. (I say "available share class" because not all share classes are generally available to smaller plans. Obviously, fiduciaries do not need to consider share classes that they can't invest in. However, there is a fiduciary "duty to ask" about the available share classes.) The second is to select a higher-cost share class (for example, retail shares) where the increased expense can be justified by revenue sharing for operating the plan, for example, for compensation to the recordkeeper and adviser. Both alternatives are legally permissible.

However, there are several issues. Some of those are:

- Who should decide whether to use higher cost share classes that pay revenue sharing for plan expenses?

Unfortunately, there isn't any specific guidance on that question. However, in my experience, most advisers believe that plan fiduciaries should decide whether expenses are paid by revenue sharing, by the plan sponsor, or by charges to the participants. Accordingly, the first step for an adviser is to consult with the plan fiduciaries to determine whether the adviser should recommend the lowest-cost available share classes or whether the adviser should recommend share classes that pay reasonable amounts of revenue sharing to offset plan expenses. (Where the mutual funds pay more revenue sharing than is needed for reasonable plan expenses, the excess should be restored to the plan and the participants. For example, that might be done through an expense recapture account.)

- What is the adviser's responsibility?

When a fiduciary adviser recommends mutual funds to the plan fiduciaries (e.g., the plan committee), the adviser should recommend the appropriate share class for that plan. In other words, the adviser should evaluate the mutual fund share classes in light of the revenue sharing decisions made by the plan fiduciaries.

- What are the adviser's subsequent responsibilities?

The Tibble decision also held that the plan fiduciaries have an ongoing duty to monitor for these purposes. As a result, if a fiduciary adviser is providing monitoring advice, the share class issue needs to be re-visited at reasonable intervals. There's no specific guidance on the appropriate timing of those reviews, but advisers need to consider the issue when developing and communicating their monitoring recommendations.

While both of the alternatives—that is, no revenue sharing and revenue sharing share classes—are available, the easier course of action would be to use the lowest-cost share class (and, if possible, non-revenue paying shares). Where some of the investments pay revenue sharing, the plan can be immunized by returning that revenue sharing to the participants who hold shares of those mutual funds (which is sometimes called "levelization" or "equalization"). In this case, the scope of monitoring is reduced and the plan is more transparent.

My point in writing this article is that Tibble impacts advisers as much as it impacts responsible plan fiduciaries. As a secondary, but important risk management matter, fiduciary advisers need to consider whether their discussions with plan committees about revenue sharing are adequate to enable the plan fiduciaries to fully understand the issues and to make informed decisions. The Tibble decision is an important reminder that, when mutual funds are recommended, an adviser needs to focus on the appropriate share class and needs direction about the use of funds that pay revenue sharing.

Forewarned is forearmed.

The views expressed in this article are the views of Fred Reish, and do not necessarily reflect the views of Drinker Biddle & Reath.

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