Plan Fiduciary Responsibilities under the DOL's Service Provider Disclosure Rules - What Do I Do With All These Fee Disclosures?

Jul 10 2012

Posted By: Kenneth A. Hoogstra

Practice Area: Compensation and Benefits/ERISA

Under Department of Labor ("DOL") regulations that became effective July 1, 2012, a retirement plan's contract or arrangement with a covered service provider constitutes a prohibited transaction unless the service provider and plan fiduciary comply with disclosure requirements under Section 408(b)(2) of the Employee Retirement Income Security Act ("ERISA"). Plan fiduciaries ultimately bear responsibility for ensuring that they receive complete disclosures under ERISA Section 408(b)(2), and that the plan pays reasonable compensation to service providers. If a plan has an unreasonable arrangement or contract with its service provider, the plan fiduciary may be subject to significant penalties under ERISA or the Internal Revenue Code (the "Code"). Thus, plan fiduciaries should ensure that they understand the disclosure rules described in this article.

As a Plan Administrator, Do I Have Any Disclosure Obligations Under the DOL Regulations?

Although plan administrators do not have disclosure duties under the new ERISA prohibited transaction regulations, they do have disclosures obligations to participants under new ERISA fiduciary regulations if their plans allow participants to direct the investment of their individual accounts. Under these regulations, plan administrators must make annual and quarterly disclosures to participants of certain "plan-level" information. For example, they must disclose the manner in which investments can be directed and the general administrative expenses and individual expenses that may be charged against the participant's account. They must also disclose "investment-level" information, such as historical performance data, benchmarks, and fee and expense information for each investment alternative. For calendar year plans, the initial annual disclosure of plan-level and investment-level information must be furnished no later than August 30, 2012, which is 60 days after the July 1 effective date of the new prohibited transaction regulations. The first quarterly statement must then be furnished no later than November 14, 2012, which is 45 days after the end of the third quarter (July through September), during which initial disclosures were first required. The quarterly statement must reflect the fees and expenses actually deducted from the participant's account during the quarter to which the statement relates.

BACKGROUND
ERISA Section 406 generally prohibits a party in interest (such as a plan fiduciary or a service provider) from furnishing goods, services or facilities to a plan. However, ERISA Section 408(b)(2) exempts a contract or arrangement from this prohibited transaction rule if the contract or arrangement is reasonable, the services are necessary, and the plan pays no more than reasonable compensation for the services.

Prior to the DOL's adoption of the new disclosure rules, the regulations under ERISA Section 408(b)(2) provided little guidance as to when a contract is considered "reasonable." The regulations stated only that a contract is not reasonable if it does not permit the plan to terminate the contract without penalty on short notice. On July 16, 2010, the DOL issued interim final regulations providing that an arrangement between a service provider and a plan is not reasonable unless the service provider discloses specific information to the plan regarding compensation. The disclosure regulations were later finalized, and became fully effective on July 1, 2012.

NEW DISCLOSURE RULES
Going forward, covered service providers must generally provide a disclosure that complies with ERISA Section 408(b)(2) reasonably in advance of the date that the covered service provider and the plan first enter into a contract or arrangement, as well as whenever the contract or arrangement is extended or renewed. If any change is made to the information provided in the disclosure, the covered service provider must report the change as soon as practicable, but not later than 60 days after the covered service provider is informed of the change.

Plans to Which Disclosure Requirements Apply
The disclosure rules apply to defined contribution and defined benefit retirement plans that are subject to ERISA. Thus, the new rules do not apply to health plans, prescription drug plans or welfare benefit plans. In addition, non-ERISA plans, such as church and governmental plans, are not subject to the fee disclosure rules. The final regulations also do not apply to simplified employee plans, SIMPLE retirement accounts, IRAs, and certain Code Section 403(b) annuity contracts and custodial accounts that were issued and frozen prior to January 1, 2009.

Covered Service Providers
The final regulations require disclosures by "covered service providers" to ERISA retirement plans. The term ***covered service provider*** means any of the following service providers that enter into a contract or arrangement with a plan and reasonably expect to receive at least $1,000 in either direct or indirect compensation:

- Plan fiduciaries or registered investment advisors that provide services directly to a retirement plan;
- Service providers, such as investment managers, that provide fiduciary services directly to plan asset vehicles (i.e., an investment contract, product or entity that holds plan assets) in which the plan has a direct equity investment;
- Record-keepers or brokers to an individual account plan that permits participants to direct investments if an investment alternative will be made available in connection with the recordkeeping or brokerage services; and
- Other service providers that receive indirect compensation for services, including accounting, auditing, actuarial, appraisal, banking, consulting, custodial, insurance, investment advisory, legal, recordkeeping, securities or other investment brokerage, administrative, or valuation services.

Required Disclosures
Covered service providers must provide plan fiduciaries with a written disclosure that includes all of the following types of information:

- **Services**: A description of the services that will be provided to the plan under the contract or arrangement with the covered service provider, including services beyond those that make it a "covered" service provider.
- **Fiduciary Status**: A statement, if applicable, that the covered service provider will provide or reasonably expects to provide services as a fiduciary or as an investment advisor.
- **Compensation**: A description of the compensation the covered service provider expects to receive under the contract or arrangement with the plan. Such compensation may include direct or indirect compensation, compensation paid among related parties, and compensation that will be received upon termination of the contract or arrangement. If the covered service provider receives indirect compensation, it must also disclose the services for which the indirect compensation is received and the payer of the indirect compensation. ***Compensation*** includes anything of monetary value, such as money, gifts, or trips, but does not include non-monetary compensation valued at $250 or less during the term of the contract or arrangement. The term ***indirect compensation*** means compensation from a source other than the plan, plan sponsor, the covered service provider, an affiliate or subcontractor.
- **Recordkeeping**: A description of all direct and indirect compensation the covered service provider expects to receive for recordkeeping services. In addition, if the covered service provider expects to provide recordkeeping services without receiving explicit compensation for those services or if compensation for such services is offset or rebated, the covered service provider must give the plan fiduciary an estimate of the cost to the plan of the recordkeeping services.
- **Manner of Payment**: A description of the manner in which the covered service provider expects to receive payment for its services, including whether the plan will be billed or whether the compensation will be deducted directly from the plan's accounts or investments.
- **Investments (Registered Investment Advisor Fiduciary Services)**: Registered investment advisors must also provide a description of (1) any compensation charged directly against investments (e.g., commissions, sales loads, redemption fees, accounts fees, etc.) that are not included in the annual operating expenses of the investment; (2) annual operating expenses; and (3) any additional ongoing expenses. Additional disclosure rules apply with respect to designated investment alternatives (i.e., investment options into which participants and beneficiaries may direct the investment of their accounts).
- **Investments (Recordkeeping or Brokerage Services)**: A covered service provider that provides recordkeeping or brokerage services must also provide a description of the following with respect to each designated investment alternative: (1) any compensation charged directly against investments (e.g., commissions, sales loads, redemption fees, accounts fees, etc.) that are not included in the annual operating expenses of the investment; (2) annual operating expenses; and (3) any additional ongoing expenses. However, in many instances, the service provider may comply with this requirement by providing the disclosure materials of the issuer of the designated investment alternative that includes the required information.

PENALTIES FOR FAILURE TO COMPLY

If a covered service provider does not provide the plan fiduciary with the disclosures discussed above, the contract or arrangement with the covered service provider will be considered a prohibited transaction under ERISA Section 406 unless the following conditions are met:

- The plan fiduciary must have been unaware of the failure, and must have reasonably believed the covered service provider met its disclosure obligations;
- Upon discovering the failure, the plan fiduciary must request, in writing, that the covered service provider furnish the missing information;
- If the covered service provider fails to comply with such request within 90 days:
    - The plan fiduciary must notify the DOL of the failure, and must include in its notice specified information with respect to the failure; and
    - The plan fiduciary must consider terminating the arrangement or contract. However, if the requested information relates to future services, the fiduciary must terminate the contract or arrangement as soon as possible.

If the plan fiduciary does not satisfy the above conditions, the contract or arrangement will be deemed to be a non-exempt prohibited transaction subject to civil penalties under ERISA or excise taxes under the Code.

PLAN FIDUCIARY ACTION STEPS
By now, a plan fiduciary should have received fee disclosures from all of the plan's covered service providers. Although the obligation to provide the fee disclosures falls on the covered service provider, the plan fiduciary is ultimately responsible for confirming it has received a fee disclosure from each covered service provider and that each disclosure complies with the final regulations under ERISA Section 408(b)(2). Accordingly, it is important that a plan fiduciary take the following steps in response to the DOL regulations:

- Confirm that it has identified its covered plans;
- Confirm that it has identified all covered service providers with respect to each plan;
- Confirm that each covered service provider has made a fee disclosure pursuant to the DOL regulations; and
- Thoroughly review all disclosures it has received from covered service providers to confirm that they satisfy the requirements of the DOL regulations.

If a plan fiduciary does not receive a disclosure, or receives an incomplete disclosure, from a covered service provider, the fiduciary may need to notify the DOL and terminate the arrangement or contract, as explained above.

In addition, the plan fiduciary must determine whether the plan pays reasonable compensation to its service providers, as compared to compensation paid by other similar plans to service providers. It may be prudent for a plan fiduciary to initiate a request for proposal process or to engage an independent consultant to perform a benchmarking process. In any case, the plan fiduciary should create a record, such as meeting minutes or an internal memorandum, showing that the plan fiduciary reviewed the service provider disclosures, determined whether the compensation was reasonable, and took any appropriate actions based on its determinations. Further, the plan fiduciary should be prudent when selecting new service providers and should regularly monitor compensation paid to existing providers. A plan fiduciary's record of such due diligence will be helpful if employees or the DOL express concerns regarding the reasonableness of service provider fees.
