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SPECIAL REPORT AND ANALYSIS

408(b)(2): Fee and Compensation Disclosure Regulations are Finally Here

On July 16, 2010 the Department of Labor (DOL) published an interim final regulation on ERISA Section 408(b)(2) which will become effective on July 16, 2011. An "interim final regulation" is final but subject to some modification based on additional input, which is why the effective date has been delayed. The proposed regulation was originally published in 2007, and a change in the Executive branch plus Congressional input caused the DOL to postpone the release of final regulations.

This regulation affects all qualified plans, which includes 49,000 defined benefit plans with 42 million participants and almost 646,000 defined contribution plans with 80 million participants.

Kidder Benefits Consultants, Inc. is a "covered service provider" as defined under Section 408(b)(2) and considers this a positive step for our industry, plan sponsors and plan fiduciaries.

Background

The current regulations under ERISA Section 406(a)(1)(C) prohibit the furnishing of services between a plan and a party-in-interest. Any person or entity dealing with an ERISA plan i.e. 401(k), 403(b), Profit Sharing, Defined Benefit, Cash Balance is considered a "party-in-interest" and cannot receive compensation from the plan unless they are covered under an exemption. ERISA Section 408(b)(2) provides an exemption for service providers to a plan if 1) the contract or arrangement is reasonable, 2) the services are necessary for the plan; and 3) no more than reasonable compensation is paid. In essence, a "party-in-interest" is guilty until proven innocent by reason of an exemption like 408(b)(2). Under Internal Revenue Code Section 4975 there is a similar prohibition.

The purpose of the new regulation is to define and provide guidance as to what is required of a service provider to demonstrate what is "reasonable", what type of information must be disclosed to the "responsible plan fiduciary", and when it must be disclosed.

As defined by the regulation, a "responsible plan fiduciary" is "a fiduciary with authority to cause the covered plan to enter into, or extend or renew, the contract or arrangement." This can be one or more people, a committee, a trustee or a board. By satisfying the terms of the regulation, the "responsible plan fiduciary" will have the information necessary to make informed decisions and satisfy their fiduciary obligations. For the service provider, such an arrangement will be considered reasonable and not a prohibited transaction.

The DOL commented that it believes lack of disclosure and transparency and the conflicts they create "obscures the true cost of plan services and allows harmful conflicts to persist in the market." The bottom line is that fees and compensation for services to be provided (both direct and indirect) are to be disclosed in writing to the responsible plan fiduciaries. The disclosure of all types of compensation will also uncover any conflicts of interest.

COMMENT: *This regulation is not about finding the lowest cost provider. It is about plan fiduciaries knowing in a consistent manner from vendor to vendor what services they are purchasing, what they are paying and who is getting paid. This will allow them to better determine the quality and quantity of services received in comparison to the cost paid.*

Every plan has its own unique situation and cost structure. Differences in cost structure can be based on many varying aspects such as complex plan design, allocation formulas, multiple locations and/or quantity of participant education, different investment choices, and fiduciary issues, which can result in cost differences. That is understandable and justified if the value received for the service can be compared to the cost paid.

I. Who is Covered?

The regulation uses the terms "covered plan" and "covered service provider." To shorten this discussion, "covered plan" will be referred to as "plan", and "covered service provider" will be referred to as "provider." A plan is one covered under ERISA. It does not include an IRA, a SIMPLE IRA, and a SEP IRA. A provider is included if it enters into an arrangement with a plan and reasonably expects to receive $1,000 or more in compensation, direct or indirect, in connection with services covered in the regulation.

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Covered services and providers can be categorized as follows:

A. Fiduciary or Investment Advisory Services:
1. Services provided as a fiduciary directly to the plan under ERISA Section 3(21). This is basically a type of discretionary investment advisory service;
2. Services provided as a fiduciary to an investment contract, product, or entity that holds plan assets and in which the plan has a direct equity investment; or
3. Services provided directly to the plan as an investment adviser registered under the Investment Advisors Act of 1940 or any State law.

B. Recordkeeping Services or Brokerage Services:
Provided to a plan that is an individual account plan, i.e. participant directed accounts through a platform, and if one or more designated investment alternatives will be made available. A "designated investment alternative" is defined as "any investment alternative designated by a fiduciary into which participants may direct the investment of assets", but does "not include brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants to select investments beyond those specifically designated."

Recordkeeping services include services related to plan administration and monitoring of plan and participant and beneficiary accounts, records, statements and transactions such as enrollment, payroll deductions and contributions, offering designated investment alternatives and other investments, loans, withdrawals, and distributions.

C. Services for Indirect Compensation:
Accounting, auditing, actuarial, appraisal, banking, custodial, insurance, investment advisory for plan or plan participants, legal, record keeping, securities or other brokerage, third party administration, valuation services, or consulting (i.e. related to the development or implementation of investment policies or objectives, or the selection or monitoring of service providers or plan investments) to a plan for which the provider, an affiliate, or a subcontractor expects to receive indirect compensation.

COMMENT: *By covering as many parties involved with a plan that are being paid directly or indirectly from plan assets, the "responsible plan fiduciary" will not have to dig deep into the contracts to discover the true cost of a service, who is being paid for what, and how much they are being paid. They will also be able to break out the components of and charges related to the various plan services such as fiduciary governance, plan design and plan documents, plan administration and compliance, tax reporting, investment platform charges, investment fund expenses, and participant education.*

II. What is the definition of an affiliate or subcontractor?

An affiliate is a person or entity of the provider that "directly or indirectly (through one or more intermediaries) controls, is controlled by, or under common control with such person or entity; or is an officer, director, or employee of, or partner in, such person or entity."

A subcontractor "is any person or entity (or an affiliate of such person or entity) that is not an affiliate of the covered service provider and that, pursuant to a contract or arrangement with the covered service provider or affiliate, reasonably expects to receive $1,000 or more in compensation for performing one or more services...".

III. What needs to be disclosed and when?

The provider must disclose in writing to the "responsible plan fiduciary":
1. Services - A description of the services to be provided pursuant to the contract or arrangement.
2. Status - If applicable, a statement that the provider, affiliate, or subcontractor, will provide or reasonably expects to provide services as a fiduciary and, if applicable, a statement that the provider, affiliate, or subcontractor, will provide or reasonably expects to provide services as an investment adviser registered under either the Investment Advisers Act of 1940 or any State law.
3. Compensation - A description of all direct and indirect compensation that the provider, an affiliate or subcontractor reasonably expects to receive for the services provided, defining the services for which the compensation is received, and identifying the payer of compensation.
4. Related Parties - A description of any compensation that will be paid among related parties including the provider, affiliate or subcontractor "if it is set on a transaction basis (e.g. commissions, soft dollars, finder's fees or other similar incentive compensation based on business placed or retained) or is charged directly against the covered plan's investment and reflected in the net value of the investment (e.g. Rule 12b-1 fees);". This includes identification of the services, payer and recipient of the compensation.

COMMENT: *The intent of this regulation is good. A responsible plan fiduciary receives a written contract or arrangement which outlines the services to be provided, if the provider is also serving as a fiduciary or investment adviser, what the costs are (both direct and indirect), and how much, from whom and in*

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what manner each party is getting paid. This is now a standard approach to be applied by all providers.

A provider will no longer be able to say that their service is free. If there is direct or indirect compensation, it will need to be disclosed.

Who is serving as a fiduciary to the plan will also need to be disclosed. Generally, the investment platform provider, record keeper, and third party administrator are serving in a ministerial role and not as a fiduciary. The accountant, actuary or legal counsel, are usually not serving in a fiduciary role. However, the broker, investment adviser or consultant on fiduciary governance may or may not have been serving in a fiduciary role and will now need to disclose that role.

IV. What type of compensation, fees or costs does this apply to?

This regulation focuses on costs coming directly or indirectly from plan assets, whether pooled together or in individual participant accounts.

Compensation is defined as “anything of monetary value (for example, money, gifts, awards, and trips), but does not include non-monetary compensation valued at $250 or less, in the aggregate, during the term of the contract or arrangement.”

Direct compensation “is compensation received directly from the covered plan.”

Indirect compensation “is compensation received from any source other than the covered plan, the plan sponsor, the covered service provider, an affiliate, or a subcontractor...”.

If the compensation cannot be reasonably expressed, then “a description or an estimate of compensation may be expressed as a monetary amount, formula, percentage of covered plan’s assets, or per capita charge for each participant”...“any description or estimate must contain sufficient information to permit evaluation of the reasonableness of compensation.”

V. What about providers that bundle services together?

If the provider reasonably expects recordkeeping services to be provided without explicit compensation for such recordkeeping services, or when compensation is offset or rebated based on other compensation received by the provider, an affiliate, or a subcontractor, then a reasonable and good faith estimate must be made of the cost.

In such a case, the estimate of the cost to the plan of such recordkeeping services, including an explanation of the methodology and assumptions used to prepare the estimate and a detailed explanation of the recordkeeping services to be provided is required. The estimate is to take into account the rates that the provider, an affiliate, or subcontractor would charge to or be paid by third parties or the prevailing market rates for similar recordkeeping services.

COMMENT: *Many bundled providers, mutual fund companies and payroll companies have packaged their services together and in the sales process indicated that a service was free or less expensive than a competitor. However, the costs were imbedded in other charges that may or may not have been disclosed. The plan fiduciaries could not easily determine how much the plan sponsor or the participants were really paying. The regulation’s required transparency of costs will help all plan fiduciaries.*

VI. Are fees billed to and paid by the plan sponsor and not paid from plan assets subject to the regulation?

In general, fees billed to and paid directly by the plan sponsor are not part of this definition as those fees are coming from plan sponsor or company assets and not plan assets. Care must be taken, however, to provide assurance that these fees are not indirectly coming from plan assets.

VII. What about disclosure of investment fund and related expenses?

In most situations, the investment related costs are the largest overall plan cost so adequate disclosure is also critical here. Each provider must disclose the following:

1. Compensation charged “directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal from the investment contract, product, or entity (e.g. sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees);
2. “A description of the annual operating expenses (e.g. expense ratio) if the return is not fixed: and
3. “A description of any ongoing expenses in addition to annual operating expenses (e.g. wrap fees, mortality and expense fees).”

COMMENT: *Over the past several years, most investment platforms, mutual fund companies and insurance companies have significantly improved the disclosures described above. The issue prompting a great deal of this new regulation relates to a better description and explanation as to who is getting paid, how much and for what service. Historically, the breakout of the annual operating expenses and/or wrap fees as to how*

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much went to other providers, advisers, etc. was very difficult to determine. The new disclosures combined with the other provisions in the regulation now provide a better opportunity to review the various plan services costs.

VIII. How are termination costs disclosed?

To be “reasonable” according to the regulations, the contract or arrangement must permit termination by the plan without penalty on reasonably short notice in order “to prevent the plan from becoming locked into an arrangement that has become disadvantageous.” However, a provision “which reasonably compensated the service provider or lessor for loss upon early termination of the contract, arrangement, or lease is not a penalty. For example, a minimal fee in a service contract which is charged to allow recoupment of reasonable start-up costs is not a penalty.”

Again, the provider must disclose any compensation that they reasonably expect to receive in connection with the termination. In addition, it must disclose how any prepaid amounts will be calculated and refunded upon termination.

IX. When does the disclosure need to be provided?

A provider must disclose the required information “in advance of the date the contract or arrangement is entered into, and extended, or renewed”. There are exceptions that involve information that becomes available at a later date. If there are items added after the fact, the information and timing of such disclosure depends on the situation. In general, the regulation states disclosure must be “as soon as practicable” and depending on the situation, not later than 30 or 60 days.

X. What if the provider does not comply or compliance is not mandated by the responsible plan fiduciary?

As mentioned earlier, ERISA Section 408(b)(2) provides an exemption from the prohibited transaction rules of ERISA Section 406(a)(1)(C). There is a parallel provision in the Internal Revenue Code (IRC) under Section 4975. The IRC provides for the imposition of excise taxes for failure to follow the regulations.

According to the regulation, if a provider fails to disclose the required information (or does not make the corrections according to the rules), then the contract or arrangement will not be “reasonable”. Therefore, the service contract will not qualify for relief from ERISA’s prohibited transaction rules provided by 408(b)(2).

The resulting prohibited transaction has consequences for BOTH the responsible plan fiduciary and the provider. According to the regulation commentary, the responsible plan fiduciary, by causing the action, will have violated ERISA Section 406(a)(1)(C) and (D). As a result, a breach of fiduciary duty will have occurred subjecting the fiduciaries to a potential lawsuit. In addition, the provider, as a “disqualified person” (“party-in-interest” is the term used in ERISA) under the IRC prohibited transaction rules will be subject to penalties and excise taxes that result from the provider’s participation in a prohibited transaction under IRC Section 4975.

These penalties include the restoration to the plan of the amount involved, return of all dollars compensated, and a possible excise tax of 15% for each prohibited transaction. If not corrected within the taxable year and after the initial tax is imposed, an excise tax of 100% of the amount involved may be imposed. So, not only does the service provider have to return the compensation, but they also pay an excise tax on that amount.

However, even if the provider fails to disclose information the regulations provide an exemption under ERISA Section 406(a)(1)(C) for the “responsible plan fiduciary”. The “responsible plan fiduciary must meet the following conditions: A) “the responsible plan fiduciary did not know that the covered service provider failed or would fail to make the required disclosures and reasonably believed the provider disclosed the information”, and B) upon discovery, they request “in writing that the covered service provider furnish such information”, and C) if the provider fails to comply with such written request within 90 days, the “responsible plan fiduciary notifies the Department of Labor”. The DOL notification requirements describe it as not later than 30 days following the earlier of 1) the refusal to provide the information requested, or 2) 90 days after the written request.

The responsible plan fiduciary following discovery of a failure to disclose shall determine whether to terminate or continue the arrangement. Evaluation should include the nature of the failure, the availability, qualifications, and cost of replacement providers, and the provider’s response to the notification of failure.

COMMENT: *Providers have both DOL and IRS prohibited transaction penalties to consider. The IRS excise taxes of 15% to 100% in addition to reimbursing the plan for all compensation received will provide the financial incentive for compliance.*

CONCLUSION:
For the plan sponsor and “responsible plan fiduciary”, it becomes even more critical to work with providers with sufficient expertise, experience and knowledge in this area to avoid fiduciary missteps. If you have any questions or want to know how Kidder Benefits Consultants, Inc. can support plan sponsors and plan fiduciaries in this area, please contact us.

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