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Update on Service Provider Disclosure Under 408(B)(2)

By Fred Reish and Bruce Ashton

Over the last 10 months, we've released a number of bulletins discussing the DOL's proposed regulation under ERISA Section 408(b)(2). We anticipated that the regulation would be released in final form no later than mid-December (the DOL had completed its work on the regulation and forwarded it to the federal Office of Management and Budget, the final step for the issuance of federal regulations, in September), but as of today, the final regulation has not been issued.

As a brief reminder, the proposed regulation explains the prohibited transaction exemption in ERISA that requires contracts and arrangements between plans and service providers to be "reasonable." To be reasonable, the DOL said that such contracts must be in writing, and there must be advance disclosure of the services to be provided, the compensation to be received for those services and potential conflicts of interest that could impact the services being provided.

At this point, the final regulation may be released any day, or it may not be released until after the inauguration of President Obama, or it may not be released at all, at least in its present form. And, even if it is published in final form, we anticipate that Congressman George Miller (the chair of the House Education and Labor Committee) will introduce legislation that imposes even greater disclosure requirements.

What if there is no 408(b)(2) Regulation?
So what happens now? Can service providers retain their current contract and disclosure practices which, depending on the services provided and the current practices of the provider, may not include many of the disclosures contemplated by the proposed regulation?

Our answer is "no" for three reasons:

1. **The ERISA Requirement.** Even without the final regulation, from a risk management perspective, the prudent course for service providers is to make the types of disclosures provided for in the proposed regulation. We say this because of the fiduciary and prohibited transaction rules under ERISA.

   The DOL has said that fiduciaries have an obligation to

   > "assure that the compensation paid directly or indirectly by [a plan to a service provider] is reasonable, taking into account the services provided to the plan as well as any other fees or compensation received by [the service provider] in connection with the investment of plan assets. The responsible plan fiduciaries therefore must obtain suffi cient information regarding any fees or other compensation that [the service provider] receives with respect to the plan's investments…to make an informed decision whether [the service provider's] compensation for services is no more than reasonable." (Advisory Opinion 97-16A; *see also* similar language in Advisory Opinion 97-15A.)

   Thus, there is a legal duty on the part of the fiduciaries to obtain the information that the proposed regulation requires service providers to disclose.

   Further, ERISA §406(a)(1)(C) provides that the "furnishing of goods, services or facilities between a plan and a party in interest" is prohibited. (There is a parallel provision in section 4975 of the Internal Revenue Code.) The term "party in interest" includes any service provider to a plan. So if an arrangement between a plan and a service provider is prohibited, how does a plan obtain services?

   ERISA §408(b)(2) provides an exemption for "contracting or making reasonable arrangements with a party in

interest for…services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor." (We use the term "contract" to refer to both "contracts or arrangements.") The existing DOL regulation under this section (Reg. §2550.408b-2) says that three requirements must be met in order for the exemption to apply: (i) the service must be necessary for the establishment or operation of the plan; (ii) the service must be furnished under a contract that is reasonable; and (iii) no more than reasonable compensation may be paid for the service. The regulation then says that a contract will not be considered reasonable unless the plan may terminate it "without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous." There is no requirement for upfront disclosure.

Nevertheless, the law requires that service provider contracts be "reasonable" in order to be exempt from the prohibited transaction restrictions, and "reasonable" is a broad term open to many possible interpretations. Even if the proposed regulation is never finalized, it reflects a position taken by the DOL that, in conjunction with the fiduciary obligation to obtain information about services and compensation, the agency could use in future investigatory or litigation proceedings, that private litigants might adopt or that the courts might use in assessing whether a given contract was "reasonable."

Given these possible uses of the DOL's interpretation, even if the regulation is not finalized, we believe it would be prudent for service providers to use the approach outlined in the proposed regulation to avoid problems in the future. That is not to suggest that literal compliance with the proposed regulation will be required. However, we believe that courts could find that the failure to disclose information that a reasonable fiduciary would need to consider to engage in a prudent process could mean that the contract was unreasonable and that therefore, the arrangement was a prohibited transaction.

2. **Impact of Schedule C.** For service providers to larger plans, disclosures similar to those required in the proposed regulation will be required – at least for compensation and services, even if no final regulation is issued. This conclusion is based on the Form 5500 reporting requirements that are effective for plan years beginning in 2009.

   The 2009 Form 5500 expands the requirements for reporting of direct and indirect service provider compensation on Schedule C for plans with 100 or more participants. While this is after-the- fact reporting, one component of the new Schedule C imposes an up-front disclosure obligation on service providers in order for the plan to make use of simplified reporting (*i.e.*, so called "check-the-box" reporting).

   The 2009 Schedule C requires reporting by plan sponsors of direct and indirect revenues received by service providers that are paid at least $5,000 during the plan year. For this purpose, reportable compensation includes money and any other thing of value received by a person, directly or indirectly, from a plan (including fees charged as a percentage of assets and deducted from investment returns) in connection with services rendered to the plan or the person's position with the plan. This definition is essentially the same as that used in the proposed 408(b)(2) regulation.

   Direct compensation paid by a plan must be reported as a specific dollar amount. Indirect compensation must also be disclosed in substantial detail, including the name of the service provider, the type of service, the amount of indirect compensation, the source of the indirect compensation and a description of the indirect compensation or the formula used to determine the amount. If a service provider fails or refuses to provide the information, this must be disclosed on the Schedule C, presumably in order to give the DOL an opportunity to conduct an investigation of the service provider to determine why it is refusing to assist the plan sponsor with its ERISA reporting obligations.

   This detailed disclosure can be avoided, however, if the service provider receives only "eligible indirect compensation." (For our purposes, a general – though incomplete – definition of compensation that qualifies as eligible indirect could be a payment that reduces the value of a plan's investments, for example, a 12b-1 fee paid to a broker-dealer. Having said that, we should also point out that the DOL has given guidance that creates confusion about whether all 12b-1 payments would be eligible for that treatment.)

   For eligible indirect compensation, the reporting requirement is greatly simplified: the plan sponsor may simply check a box indicating that it is excluding more detailed reporting other than the name of the person who provided the required information (described below).

   This simplified reporting is not available, however, unless the service provider has given written disclosures to the plan sponsor describing: the existence of the indirect compensation; the service provided; the amount (or

estimate) of the compensation or a description of the formula used to compute the compensation; and the identify of the parties paying and receiving the compensation. For those familiar with the proposed 408(b)(2) regulation, you will see that these disclosures are very similar to those required by the proposed regulation.

In our view, service providers that receive eligible indirect compensation – including, for example, broker-dealers that receive 12b-1 fees – may prefer to make the up-front disclosures needed for this compensation to be considered "eligible" for the check-the-box reporting on Schedule C rather than have to provide information in significant detail after the end of the plan year. For these service providers, the absence of mandated disclosure under a 408(b)(2) regulation will not impact the way in which they do business with their clients.

As a result, for Schedule C purposes, 408(b)(2)-like disclosures will be required to be made to plan sponsors or the sponsor will be required to report, as a public record, extensive information about the indirect compensation of the service provider.

To fully appreciate the scope and impact of this requirement, one needs to understand that, to determine if a 401(k) plan has 100 participants, all of the eligible employees must be counted, even if they do not have account balances. As a result, the requirement covers more plans than it might appear to.

3. **Best Practice.** In our view, complete transparency of services, compensation and potential conflicts of interest is simply a best practice, regardless of whether it is required by DOL regulation, pressure from class action suits or the reporting rules under ERISA. Increasingly, plan sponsors are becoming educated to both their obligations to their participants to provide them with appropriate investments and services at a reasonable cost – and thereby to assist them in accumulating adequate retirement savings. Plans sponsors are coming to expect full disclosure from service providers: what services will my participants get; what will it cost them; and to what extent do you have a conflict in providing that service?

   As a result, we believe that some service providers will adopt the standards of the regulation as best practices, even if it is not finalized, and will use those practices to their competitive advantage.

Conclusion

We may or may not see a DOL regulation mandating disclosure of service provider compensation and conflicts in the immediate future. Even if a regulation is issued, it may take a form different from the proposal. Nevertheless, in our view, disclosure of the information called for in the proposed regulation

- is valuable for risk management purposes to avoid legal problems that may arise from a failure to disclose,
- is helpful to assist plan sponsors in meeting reporting requirements on the Schedule C to the Form 5500, and
- is consistent with best practices.

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