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THE OBLIGATIONS OF PLAN SPONSORS AND PLAN FIDUCIARIES UNDER THE SERVICE PROVIDER DISCLOSURE REGULATIONS

The Department of Labor (DOL) has issued a series of regulations and guidance that will affect qualified retirement plans beginning in 2012. Many of the changes are only applicable to defined contribution plans (like profit sharing plans and 401(k) plans) where participants are allowed to direct their investments. Other regulations affect all qualified retirement plans. Your investment advisor or third party administrator may have already spoken to you about these changes. If not, you may wish to contact them concerning the information they must disclose to you and what you must disclose to your plan participants.

This is the second of three articles describing these new regulations and guidance and will cover what plan service providers must disclose about their services, compensation and fiduciary status. In particular this article will focus on why plan sponsors and plan fiduciaries need to pay close attention to these disclosures.

1. <u>What is the Deadline for Service Provider Disclosures?</u>

Service providers must make their initial disclosures by April 1, 2012. DOL originally issued the service provider disclosure regulations as "interim final regulations" which would go into effect without further action. DOL promised, however, that there would be further guidance. As of yet, that additional guidance has not been forthcoming so there is a ***possibility*** that this deadline may be extended.

2. <u>What are the Reasons for this Increased Disclosure?</u>

DOL noted that the way services are provided to qualified retirement plans has changed as has the way service providers are compensated. While these changes may have improved efficiencies in many instances they also created complexities in fee arrangements that made it difficult for plan sponsors and fiduciaries to understand the compensation service providers are actually receiving.

3. <u>Why Should I Care About These Disclosures?</u>

The disclosures are designed to make sure that plan fiduciaries are informed about how much they are actually paying for services so they can then perform an analysis of whether that compensation is reasonable. Plan fiduciaries are required under the

Employee Retirement Income Security Act of 1974 (ERISA) to make this analysis. Plan fiduciaries include plan trustees, the employer itself (if it is serving as the plan administrator) as well as plan administrative or investment committees. Finally as detailed at the end of this article, plan fiduciaries who do not receive the required disclosures and do not make sufficient efforts to obtain the disclosures will have committed a "prohibited transaction" under ERISA and the Internal Revenue Code.

4. Which Plans are Covered?

The regulations apply to all qualified defined contribution plans (profit sharing plans, 401(k) plans, money purchase pension plans) as well as to all defined benefit plans. The regulations also apply to 403(b) plans covered by ERISA. The regulations do not apply to SEPs, SIMPLEs, welfare plans and plans not subject to ERISA such as governmental plans, church plans and "owner only" plans.

5. Which Service Provider Must Make Disclosures?

The regulations only require disclosure from service providers receiving direct or indirect compensation from the ***plan***. If compensation is received only from the plan sponsor (the employer) and not the plan itself, then disclosure is not required. The following entities receiving compensation (direct or indirect) from a plan must make disclosures:

- Fiduciaries and registered investment advisors.
- "Platform" recordkeeping or brokerage service providers. Platform providers are brokers or recordkeepers that provide services to an individual account plan (typically a 401(k) plan, profit sharing plan or ERISA covered 403(b) plan) which permits participants to direct the investment of their accounts in one or more designated investment alternatives made available in connection with the brokerage or recordkeeping services.
- Certain recipients of "indirect compensation". This would include providers receiving indirect compensation in the following service areas: accounting, auditing, actuarial, appraisal, banking, consulting (relating to investments or monitoring investment service providers), custodial, insurance, investment advice, legal, recordkeeping, brokerage, third party administration, and valuation. It would therefore include recordkeeping and brokerage service providers receiving indirect compensation even if they are not platform providers.

6. What is Indirect Compensation?

Indirect compensation is money or any other thing of value a service provider receives in connection with the plan other than compensation received directly from the plan or the plan sponsor. For example, a 12-b1 "marketing fee" from a mutual fund received by a recordkeeper, broker, or investment advisor is a very common form of indirect compensation. So too are sub-transfer agent fees (referred to as Sub TA fees).

7. Who Should Receive the Disclosures?

Covered service providers must provide the disclosures to the "responsible plan fiduciary." The responsible plan fiduciary is defined as the fiduciary with authority to cause the plan to enter into, extend, or renew the contract or arrangement with the service provider.

8. What Must be Disclosed?

Each covered service provider must provide the following information ***in writing*** to the responsible plan fiduciary (while there is no requirement for a contract with the service provider a formal contract may be desirable in most instances):

- *A description of services*. There is currently no required format for this description, but there should be sufficient information for you to determine what exactly the service provider is doing so that you can then determine whether the compensation is reasonable.
- *Fiduciary status.* If the covered service provider is an ERISA fiduciary or registered investment advisor there must be an affirmative statement of this status.
- *Any direct compensation* (paid by the plan). An invoice to the plan from the service provider based on a flat fee or based on a percentage of plan assets would be an example of direct compensation.
- *Any indirect compensation* (must provide the payer of the compensation). This is the primary focus of the regulations so that plan sponsors and fiduciaries can understand any indirect compensation that plan service providers are receiving from mutual funds or other parties.
- *Compensation paid among related parties.* Although service providers do not have to break out or "unbundle" all compensation among their affiliates or subcontractors they do need to disclose related party compensation paid "on a transaction basis" (*e.g.*, commissions, soft dollars, finder's fees or other similar incentive compensation based on business placed or retained) or compensation charged directly against the covered plan's investments and reflected in the net value of the investment (*e.g.*, 12b-1 fees).
- *Any "termination compensation*". This requires a description of any additional charges imposed if the service arrangement is terminated. While ERISA prohibits the payment of a penalty for terminating a contract, reasonable charges based on actual costs associated with early termination are permitted.
- *Manner of receipt.* This item should disclose how the compensation is received. For example, is the plan invoiced or is the compensation automatically deducted from the plan?

9. How Should Compensation be Described by the Service Provider?

There is no hard and fast rule regarding how compensation should be described. The regulations state that it may be expressed as a monetary amount, formula, percentage of the covered plan's assets, or a per capita charge for each participant or beneficiary. If the compensation cannot reasonably be expressed in these terms the regulations provide that the service provider may use any other reasonable method.

10. Are There Other Required Disclosures?

Yes. There are additional disclosure requirements applicable only to recordkeepers. In addition each platform recordkeeper or broker as well as "investment contract fiduciaries" (described below) much make disclosure concerning each of the plan's investment alternatives.

11. What Are the Additional Recordkeeper Disclosure Requirements?

Each recordkeeper, even if it's not a platform recordkeeper, must provide a description of all direct and indirect compensation the recordkeeper (and its affiliates and contractors) reasonably expects to receive in connection with the recordkeeping services. If there is no explicit compensation stated (or if compensation is offset or rebated based on other compensation received) then a reasonable and good faith estimate must be provided. The estimate must include an explanation of the methodology and assumptions used to prepare the estimate as well as a detailed explanation of the recordkeeping services provided. The estimate should take into account the rates that would be charged at prevailing market rates for a plan with similar characteristics.

Not every third party administrator (TPA) is necessarily a "recordkeeper" for purposes of these regulations. If a TPA is responsible for participant records, accounts, and statements or performs functions like loan or distribution processing then it is a recordkeeper. Certain "compliance only" TPAs that perform just testing and/or prepare 5500 forms may not be recordkeepers for the purposes of this disclosure.

12. What are the Additional Investment Disclosure Requirements?

Platform recordkeepers and brokers as well as investment contract fiduciaries must disclose certain information on each of the plan's investment alternatives. Investment contract fiduciaries are sponsors of investments where the underlying assets of the investments themselves are treated as investments of the plan under ERISA and include such things as collective trusts, insurance company separate accounts and certain non-publicly traded entities. An investment alternative ***does not*** include a directed brokerage account/window. The broker, recordkeeper or investment contract fiduciary must provide the following regarding each plan investment alternative:

- Information regarding transactional charges (sales charges/loads, deferred sales charges, surrender fees, exchange fees, etc.).
- Information regarding operating expenses (the expense ratio) if the return on the investment alternative is not fixed.
- Information regarding ongoing expenses (wrap fees, mortality and expense fees, etc.).

This information can be provided to the responsible plan fiduciary using a prospectus, summary prospectus or similar material only if:

- The investment alternative provider is not an affiliate of the covered service provider;
- The disclosure materials are regulated by a state or federal agency; and
- The covered service provider has no reason to believe that the materials are incomplete or inaccurate.

13. <u>When Must These Disclosures be Provided?</u>

The date for the initial disclosures is described in Q&A 1 above. Otherwise the disclosures must be provided to the responsible plan fiduciary reasonably in advance of the date the contract or arrangement is entered into, extended or renewed. If there are changes, the updated information generally must be disclosed to the plan fiduciary within 60 days from the date the covered service provider is informed of the change. For example a covered service provider that is a platform broker must provide information concerning the change in an expense ratio of a mutual fund within 60 days of learning of that change. Additional disclosures also must be provided within 30 days of a written request by a plan fiduciary or plan administrator.

14. <u>What Happens if the Disclosures Are Not Provided?</u>

If the disclosures are not provided then the arrangement with the service provider will be treated as a prohibited transaction under ERISA and the Internal Revenue Code. Prohibited transactions carry with them adverse tax and other consequences.

Generally arrangements between a plan and a service provider are prohibited transactions unless the services are necessary for the establishment or operation of the plan, the services are provided through a reasonable contract or arrangement, and no more than reasonable compensation is paid for those services. A service provider's compliance with its disclosure obligation is required for the arrangement with that service provider to be "reasonable." If the arrangement is not reasonable there is a prohibited transaction by both the service provider and the fiduciary.

15. <u>What Should I Do if the Disclosures are Not Provided or if I Cannot Make a Determination Regarding the Reasonableness of Compensation Based on the Disclosures?</u>

DOL recognizes that fiduciaries do not have ultimate control over service provider disclosures. If information has not been provided or the responsible plan fiduciary knows that the information does not meet the requirements of the regulations that fiduciary will not be responsible for the prohibited transaction if he or she takes the following steps:

- The fiduciary, upon discovery of the disclosure violation, requests in writing that full disclosure be provided.

- If the covered service provider fails to respond within 90 days, the fiduciary notifies DOL within 30 days of that failure (120 days from the original request for full disclosure). The regulation details the information that must be provided in this notification.
- The fiduciary then makes a determination on whether to continue to retain the service provider. This decision should include an analysis of the service provider's qualifications; the cost of a replacement provider; the reason for the disclosure failure and; the provider's response to that failure. If a service provider has failed to respond completely to a request for disclosures, that service provider presumably should be terminated.

While these rules place primary emphasis on what covered service providers must disclose, plan fiduciaries have always had the duty to insure that plan fees are reasonable. These new disclosures just provide a vehicle for making that determination of reasonableness. If disclosure is not made then the fiduciary must take the actions detailed above. Even if disclosure is made but the fiduciary does not believe that he or she has sufficient information to make a reasonableness determination then further action by that fiduciary is required. The preamble to the regulation itself explains that: "Ultimately, though, the responsible plan fiduciary must...decide whether it has enough information about the services to be provided pursuant to the contract or arrangement to determine whether the cost of such services to the plan is reasonable. Accordingly, if a particular description of services lacks sufficient detail to enable the responsible plan fiduciary to determine whether the compensation to be received for such services is reasonable, the responsible plan fiduciary must request additional information."

If you have any questions concerning these new service provider disclosure regulations, please contact Kenneth M. Johnson at Tuggle, Duggins & Meschan, P.A., 100 N. Greene Street, Suite 600, Greensboro, NC 27401, (336) 271-5264.