

## **ErisaALERT**

September, 2008

### **Fee Transparency**

#### ***Part 2 – Reasonable Contract or Arrangement Under Section 408(b) (2)—Fee Disclosure***

As noted in Part 1 of our three part Fee Transparency series ( which can be found at <http://www.erisadiagnostics.com/erisaalerts.asp?articleID=3>), there are three pieces of DOL guidance that Plan Sponsors should have on their list of “to dos”. Two are in the form of proposed guidance with the third in final form. This ErisaALERT is the second in our three part series dealing with the guidance and their implications for Plan Sponsors.

#### **Recap of the Guidance**

The combined guidance addresses:

- reporting plan expense information on Schedule C.
- information that must be disclosed to plan participants (Part 1 of our series)
- information which must be provided by the service provider to a responsible plan fiduciary especially where fees will be paid from plan assets.

In this ErisaALERT we will discuss the last bullet noted above referred to as the Reasonable Contract or Arrangement Under Section 408(b)(2)—Fee Disclosure guidance and its impact on Plan Sponsors. This guidance touches on some very important basics of fiduciary responsibility.

#### **Historical Background**

ERISA permits the payment of plan expenses from plan assets as long as they are “reasonable”; however, the definition of “reasonable” was sorely lacking and the definition was key to preventing a prohibited transaction.

ERISA provides that any person providing services to a plan is considered a party in interest and further provides that it is a prohibited transaction for a party in interest to provide services to a plan unless protected under a prohibited transaction exemption. ERISA 408(b)(2) provides relief from the prohibited transaction rules for service contracts or arrangements between a plan and party in interest if no more than reasonable compensation is paid for services.

ERISA requires plan fiduciaries to act in the best interest of plan participants which includes using plan assets for the exclusive benefit of plan participants. This implies that plan fiduciaries should minimize expenses charged to the plan to the extent possible.

Plan fiduciaries have the duty to select and monitor plan providers. Fundamental to this responsibility is having enough information to make an informed decision about the costs as well as the services provided.

In the preamble to the proposed regulations, the DOL acknowledges that the way in which administrative services are provided to Plan Sponsors has become increasingly complex and this complexity has made it more difficult for fiduciaries and Plan Sponsors to understand exactly what they are paying for. The DOL believes that guidance is needed to help both service providers and plan fiduciaries understand what constitutes a “reasonable contract or arrangement”.

## **The Proposed Rules**

Basically, the proposed regulations apply to anyone who provides services to an employee benefit plan including services provided:

- A) as fiduciary as defined in ERISA or under the Investment Advisers Act of 1940;
- B) pursuant to a contract or arrangement which includes one or more of the following services:
  - a. banking
  - b. consulting
  - c. insurance investment advisor (plan or participants)
  - d. investment management
  - e. recordkeeping
  - f. securities or other investment brokerage or
  - g. third party administration, or
- C) who receives or may receive indirect compensation in connection with one or more of the following services pursuant to the contract or arrangement:
  - a. accounting
  - b. actuarial
  - c. appraisal
  - d. auditing
  - e. legal or
  - f. valuation.

Such a contract or arrangement will not be considered “reasonable” unless it meets the disclosure requirements contained in the proposed regulations.

**NOTE:** It is very important to note that the preamble to the regulations refers to the above as “threshold scope requirements” and states that if a contract or arrangement meets the threshold scope requirement, the contract or arrangement must satisfy the disclosure requirement regardless of the nature of any other services provided or whether the plan is a pension plan, group health plan or other type of welfare benefit plan in order to be considered “reasonable”.

Failure to meet the requirements results in a prohibited transaction by both the responsible plan fiduciary and the service provider which results in the imposition of financial penalties on the service provider and potential litigation for the responsible plan fiduciary for failure to meet his/her fiduciary responsibility.

**Effective Date:** The regulations will be effective 90 days after the proposed rules are issued as final. In order for the proposed regulations to be effective on January 1, 2009, the regulations will have to be finalized soon!

## The contract or fee arrangement

Let’s take a look at the requirements and the practical implications “at first glance” for Plan Sponsors. There has been a lot of testimony offered by service providers and it is unknown how much of that testimony will be incorporated in the final regulations. It is important to keep in mind that the preamble to any set of regulations often provides more insight into the meaning of the regulations than the regulations themselves. That said, the preamble presents its discussion in the following key areas

- Scope of the proposal (discussed above in The Proposed Rules)
- Disclosure concerning compensation and services
- Disclosure concerning conflicts of interest
- Material changes to disclosed information
- Reporting and disclosure requirements
- Compliance by service providers

It is important to note that the disclosures required by service providers do not have to be contained in one document but may be provided via reference to multiple sources. If the information is provided via multiple sources, the service provider must indicate clearly and specifically where the information can be found.

Requirement ( <i>italics added</i> )	Practical Implications at first glance
<b>Disclosure concerning compensation and services</b>	
The contract or arrangement for services to be reasonable must be <i>in writing</i> .	Should not be a problem for most Plan Sponsors
The service provider <u>must disclose to the “responsible plan fiduciary”</u> that all the information required by the regulations was provided to the best of the service provider’s knowledge.	This may result in the Plan Sponsor certifying as to whom may make decisions and enter into agreements for the plan. Expect standard verbiage will be developed by service providers and Plan Sponsors should review contracts carefully to ensure the verbiage is there.
The terms of the contract require the service provider to disclose in writing to the responsible fiduciary <i>before the contract or arrangement is entered into</i> including: <ul style="list-style-type: none"> <li>• <i>All services</i> to be provided</li> <li>• The <i>compensation or fees to be received</i> by the service provider and</li> <li>• The <i>manner in which the compensation or fees will be received</i>. Compensation or fees include money or any other thing of monetary value received, or to be received, directly from the Plan Sponsor <u>or indirectly (i.e., any source other than the plan, the Plan Sponsor or the service provider) by the service provider or its affiliate in</u> connection with the</li> </ul>	<p>We believe that all the items in bold and italics shouldn’t be a problem for most Plan Sponsors.</p> <p>It is the underlined items that will require effort to obtain and have been at the crux of the plan fee discussion for some time.</p> <p>The availability of the fee information requires that the Plan Sponsor review, evaluate and understand the fees. Plan Sponsors without the necessary expertise should obtain it. Finally, Plan Sponsors should document their process for reviewing and assessing the fees. This includes the criteria, standards or benchmarks used to conclude the service providers’ compensation and fees are reasonable.</p>

<b>Requirement (<i>italics added</i>)</b>	<b>Practical Implications at first glance</b>
<p>services to be provided.</p> <ul style="list-style-type: none"> <li>• Compensation or fees may be expressed in a dollar amount, a formula, a percentage of plan assets or per capita charge for each participant or beneficiary of the plan. <b><u>The manner in which the fees are expressed should contain sufficient information for the responsible plan fiduciary to evaluate the reasonableness of the compensation or fees.</u></b></li> </ul>	
<p>If a service provider offers a bundle of services to the plan that is priced as a package, <b><u>only the service provider offering the bundle must provide the disclosures.</u></b> The service provider doesn't have to disclose how the fees are allocated among the various providers in the bundle <b><u>unless the fees are a separate charge against the plan's investment reflected in the net value of the investment or are set on a transaction basis, e.g., finder's fees, brokerage commissions and soft dollars.</u></b></p>	<p>Often times, even in a bundled situation the Plan Sponsor will receive separate pricing from various vendors in the bundle.</p> <p>As noted previously, the underlined required disclosure is sometimes hard for Plan Sponsor's to obtain; requiring the service provider to disclose this information will be a big help to Plan Sponsors and at the same time require the Plan Sponsor to fully understand the fees.</p>
<p>The <b><u>disclosure must state how the compensation and fees will be received</u></b> (invoiced, deducted from plan accounts, a charge against assets).</p>	<p>This is typical in our experience.</p>
<b>Disclosure Concerning Conflict of Interest</b>	
<p><b><u>Whether the service provider will provide any plan services as a fiduciary within the meaning of ERISA or the Investment Advisers Act of 1940.</u></b></p>	<p>Some providers will indicate whether or not they are a fiduciary; many do not. This requirement should be a welcome disclosure for Plan Sponsors.</p>
<p>Whether the service provider expects to participate in, or acquire a financial or other interest in, any transaction to be entered into by the plan in connection with the contract or arrangement.</p>	<p>This will most likely be a big issue for the service provider; to understand exactly what this means and then obtain the information to disclose.</p>
<p>Whether the service provider has any material financial, referral or other relationship or arrangement with a money manager, broker, other client of the service provider, other service provider to the plan or any other entity that creates or may create a conflict of interest for the service provider, and if so a description of such relationship or arrangement.</p>	<p>Similarly to the point above, this too will most likely be a big issue for the service provider: to understand exactly what this means and then obtain the information to disclose plus to ascertain the materiality of the relationship or arrangement.</p>
<p>Whether the service provider will be able to affect its own compensation or fees, from</p>	<p>The preamble to the regulations cites the use of float compensation as one example and reminds</p>

<b>Requirement (<i>italics added</i>)</b>	<b>Practical Implications at first glance</b>
whatever source, without prior approval of an independent plan fiduciary, in connection with services provided pursuant to the contract.	us that the DOL issued FAB 2002-3 to address float. The FAB can be found at <a href="http://www.dol.gov/ebsa/regs/fab_2002-3.html">http://www.dol.gov/ebsa/regs/fab_2002-3.html</a>
Whether the service provider has any policies or procedures that address actual or potential conflicts of interest or that are designed to prevent any compensation or fees from adversely affecting the provision of services to the plan; if yes, an explanation of the policies and procedures and how they address conflicts or prevent adverse effects.	The preamble states that the DOL considers this requirement as an opportunity for service providers to educate plan fiduciaries about how they address potential conflicts of interest.
<b>Material changes to disclosed information</b>	
The terms of the contract shall require that the service provider must disclose to the responsible plan fiduciary any material change to the required information not later than 30 days from the date on which the service provider acquires knowledge of the material change.	Our experience has been that service providers generally alert their clients before there is going to be any change whether “material” or not.
<b>Reporting and Disclosure Requirements</b>	
The terms of the contract shall require that the service <i>provider must disclose all information related to the contract or arrangement and any compensation or fees received</i> that is requested by the responsible plan fiduciary or plan administrator <i>to comply with the reporting and disclosure requirements of ERISA.</i>	There has always been a requirement that vendors provide Plan Sponsors with the information needed to complete the Form 5500 despite vendor protests (generally in the area of Schedule A for health and welfare plans). Given the changes required by Schedule C for 2009, Plan Sponsors may want copy and paste this section of the rules when communicating to vendors!!!
<b>Compliance by service providers</b>	
As noted previously, the service provider must comply with its obligations under the contract or the arrangement as described in the proposed regulation. The service provider must provide all the required disclosures in order for the contract or arrangement to be considered reasonable.	
A proposed prohibited transaction exemption will provide relief for a responsible plan fiduciary as a result of a service provider’s failure to comply.	This is needed since it may be virtually impossible for a Plan Sponsor to know if they are receiving all required information e.g., indirect compensation received by the service provider
<b>Carryover from existing regulations</b>	
The contract must permit termination by the plan without penalty on reasonably short notice to prevent the plan from being locked into a disadvantageous arrangement.	Virtually all contracts contain provisions for termination of the contract; the term “reasonably short” notice will require clarification

Finally, the regulations reiterate that ERISA requires that plan fiduciaries conduct a thorough due diligence in the selection of a service provider which will assess not only the reasonableness of the compensation arrangement but also the qualifications of the service provider and the quality of services provided.

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### **What should you do now?**

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1. Review your existing contracts with your service vendors in relation to the proposed regulations. Determine which contracts will be up for renewal on or after January 1, 2009.
2. Identify your “responsible plan fiduciary” with the authority to enter into arrangements for the plan.
3. Identify your internal subject matter expert or obtain appropriate expertise.
4. Review your process for evaluating vendors and document any review activity.
5. Ask your vendors regarding their ability to comply with the new rules.
6. Become familiar with other DOL related guidance on fee transparency and stay on top of any changes with respect to the effective dates.
7. Visit the DOL website <http://www.dol.gov/ebsa/fiduciaryeducation.html> and become familiar with the DOL publications regarding fulfilling your fiduciary responsibilities.

**Note:** This material is for the sole purpose of providing general information and does not under any circumstances constitute legal advice and should not be used as a substitute for legal advice. You should seek the advice of counsel when applying the requirements to your plans. For more information on this ErisaALERT, contact us by phone at 610-524-5351 and ask for Mary Andersen or 973-994-7539 and ask for Theresa Borzelli.

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