Are your retirement plan's expenses reasonable?

A guide to the retirement plan service provider fee disclosure regulations

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An odd attribute of retirement plan law states that it is illegal for a retirement plan to pay a service provider for the services rendered to the plan.

Alright, overstatement, but it got your attention didn't it?

Actually, the law does prohibit a plan from paying a party in interest to provide goods, services or facilities to the plan. The term "party in interest" includes any party that provides services to a plan. As such, the opening statement is accurate, except there is an exemption from this prohibition. A service provider may be paid by the plan for services rendered to the plan if the following conditions are satisfied:

- The contract or arrangement is reasonable;
- The services are necessary for the establishment or operation of the plan; and
- The plan pays no more than reasonable compensation for the services.

This exemption has existed since the Employee Retirement Income Security Act of 1974 (ERISA) first became effective, but there was very little formal guidance on how a plan could demonstrate compliance with these three conditions.

In response to concerns raised from numerous fronts with respect to the fees associated with plan investments and the implications of revenue-sharing arrangements with service providers, the U.S. Department of Labor (DOL) issued final regulations that provide more guidance on both when a contract is considered reasonable and what information must be provided to assist plan management in determining whether the compensation is reasonable.[1] These new rules issued under ERISA Section 408(b)(2) require compliance by July 1, 2012. There is no transition relief for existing contracts.

1 The Department of Labor has provided some informal guidance on the types of expenses that can be paid by the plan in Advisery Opinion 2001-01A and Field Assistance Bulletin 2003-3.

An arrangement with a "covered service provider" will not be a "reasonable contract or arrangement" unless the "covered service provider" provides plan management with specific written information regarding services and "direct or indirect compensation" by this date or earlier.

To apply these new rules several questions must be answered.

Which plans are subject to the revised rules?

Basically, if your retirement plan files the Form 5500 series, it is subject to these new rules. The breadth of application of this rule is important to recognize because defined contribution plans that allow for participant investment direction are required to provide information about investment fees to plan participants. It is important to recognize that the "reasonable contract or arrangement" exemption standard applies to all retirement plans,[2] not just participant-directed arrangements. There is a limited exemption for 403(b) plans that were frozen before January 1, 2009.

Who are "covered service providers"?

This question is a bit more difficult to answer than one would expect. Best practices probably dictate that plan management should pay attention to all service providers to the plan:

- Are they doing what is necessary to maintain the plan?
- Is their compensation appropriate for the services rendered?

When it comes to strict compliance with the disclosure requirements of the new regulations, however, a smaller group of service providers is involved.

First, there has to be a reasonable expectation that the service provider will receive at least $1,000 of "direct or indirect" compensation. This $1,000 cut-off applies for the term of the contract; it is not an annual limit. It can't be avoided by writing daily contracts for less than $1,000 per day. The DOL already anticipated that method of eliminating coverage.

Only certain service providers whose compensation exceeds this limit will need to provide these detailed fee disclosures to plan management. These are:

- ***Fiduciaries and registered investment advisers***. Any service provider that acts as an ERISA fiduciary, or as an investment adviser registered under state law or the Investment Advisers Act of 1940 are subject to these fee disclosure standards. Just a reminder, a "fiduciary" is someone who has discretionary authority over plan assets. A person can be a fiduciary if he or she has discretionary authority over only a portion of the plan's assets. For example, an investment manager who has discretionary investment authority over a target date arrangement that has been specifically designed for the plan is a fiduciary with respect to those assets in the target date investment arrangement.
- ***Certain providers of recordkeeping or brokerage services***. Not all providers of administrative, recordkeeping or brokerage services are "covered service providers." For example, a brokerage firm or mutual fund company that offers an administrative platform for a Section 401(k) plan would be considered a "covered service provider." Similarly, a plan administration/recordkeeping firm that has a relationship with one or more investment platforms and makes such investments available to their clients would be considered a covered service provider with respect to those clients.
- ***Service providers who receive indirect compensation***. Plans may engage many other service providers such as actuaries, auditors, tax return preparers, consultants, appraisers, attorneys, compliance firms, independent third-party administrators (TPAs), etc. Arrangements with such service providers are subject to the general rules with respect to their contracts, but they are not subject to the detailed fee disclosure standards unless the service provider or their affiliates or subcontractors can "reasonably expect" to receive "indirect compensation." It is not clear what "reasonably expect" means. However, if past practice has been to pay such fees from indirect sources or an affirmative decision has been made for the current year to use such funds, it would seem appropriate that such facts would lead to a "reasonable" expectation. The service provider may not always recognize the source of the funds with which they were paid, but plan management should have access to such information.

  The new regulations provide that "indirect compensation" is simply any compensation for services provided to the plan that is received from a source other than the plan, the plan sponsor, the covered service provider or their affiliate or subcontractor.

  EXAMPLES:
  - An actuarial firm, which is not related to or affiliated with any other service provider to the plan that provides actuarial services to a plan and is paid directly by the sponsor of the plan for those services would not be subject to the new disclosure requirements.
  - A recordkeeper to the plan that is compensated by revenue-sharing arrangements arising from investment options under the plan would be receiving indirect compensation, making its arrangement with the plan subject to these new disclosure standards.
  - An attorney performs plan amendment services for the plan and bills the plan directly. The plan fiduciary chooses to pay the bill out of funds, available under a revenue-sharing arrangement, that are not considered plan assets. At first blush, this seems to meet the definition of "indirect compensation" as the payment has not been made with plan assets or by the plan sponsor and thus, triggers the classification of the attorney as a "covered service provider." However, the attorney probably issued his or her arrangement letter in advance of the bill. At that time, did the attorney "reasonably expect" that the bill would be paid with anything other than plan assets?

2 Currently these rules do not apply to welfare plans, but it is likely that similar guidance will be issued for such plans in the future.

If not, these fee disclosure standards would not apply to that arrangement. Note this is probably splitting hairs as the attorney's arrangement letter for these services is likely to have complied with the new rules anyway.

- The independent auditor for the plan sends an engagement letter to the Plan Administrator for the 2011 plan audit. For the last three years, the check covering the audit has been drawn upon an account of the third-party administrative firm, which manages the revenue-sharing funds that are available to cover plan expenses. It is the position of that TPA firm that these are not plan assets and are available to pay its fees or any other appropriate expenses of the plan. Under these facts, given the statement that the audit fees for the last three years have been paid using funds that are not plan assets, the audit firm should "reasonably expect" the same result for 2011, so its engagement letter should comply with the disclosure requirements of these new regulations.
- The plan sponsor offers both a defined benefit plan and a defined contribution plan whose record keeping, compliance and reporting are done by the same third party administrator. That TPA subcontracts the actuarial work to an independent actuarial firm. The TPA received revenue-sharing funds from investments of the defined benefit and the defined contribution plans. The TPA pays the actuarial fees out of a portion of the revenue sharing received from the defined benefit plan. In this case, the actuary is not required to disclose its share of the indirect compensation to the plan sponsor. The TPA, however, is required to disclose both the indirect compensation it receives and it paid to the actuary as its subcontractor.

As illustrated by these examples, the conclusion of which compensation constitutes "indirect compensation" and who must provide the disclosure is not crystal clear. As such, the plan sponsor may wish to consider requesting detailed fee disclosure information from all service providers with which they have arrangements. This is a reasonable request. Otherwise, how can a buyer of services assess whether or not the services are worth what they cost unless they can accurately measure what they cost? Further, for service providers who received direct compensation, compliance with the regulations is not difficult.

For more information on what might be considered indirect compensation see page 25 of the 2011 Form 5500 Instructions. Note, however, there are some fundamental differences between what must be reported on Schedule C of Form 5500 and what must be disclosed to the plan fiduciary under the Section 408(b)(2) guidelines.

What disclosures should plan management be receiving from service providers?

In the prior discussion we have focused extensively on the fee information because that seems to be the most critical component in determining whether the fees are reasonable and, historically, it has been the most difficult item to accumulate when services providers are compensated from indirect sources. The new regulatory requirements address more than just fees.

The following items of information must be disclosed in writing by a covered service provider to the responsible fiduciary.

- ***A description of the services to be provided***. The guidance does not provide any explanation as to what is required for this point; but, plan management should look at this in light of what is required of the service provider and what they are expecting to receive. For some services, this is obvious—the auditor performs the annual plan audit. But for other service providers, more detail should be requested. For example, the plan's TPA or recordkeeper may also perform the various compliance tests for the plan. Does the description of services specify which compliance tests are performed and when? Are the tests done only for compliance purposes after year-end or are they also done for planning purposes at some time during the year? This kind of detail is helpful to plan management as they strive to assess the reasonableness of the fees being charged .
- ***Where applicable, a statement of the service provider's status as an ERISA fiduciary or registered investment adviser***. Covered service providers who are a fiduciary with respect to the plan must disclose this status, as well as the status of their affiliates or subcontractors. Likewise, registered investment advisers must disclose that fact.
- ***The compensation to be received***. The arrangement must disclose all compensation the service provider will receive in connection with the contract or arrangement, whether direct or indirect. For this purpose, direct compensation is that received from the plan. (Note, to the extent the compensation is solely paid by the plan sponsor, the arrangement is not subject to these regulations.) Indirect compensation is compensation from any source other than the covered plan or the plan sponsor. It is usually fees paid among covered service providers and their affiliates and subcontractors, such as commissions, soft dollars, finder's fees, Rule 12b-1 fees and other incentive pay based on placing or retaining business. For a good listing of the types of such fees that may be involved, the Investment Company Institute has prepared a *Sample Glossary of Investment-Related Terms for Disclosures to Retirement Plan Participants*.

  The regulations specify that the description of compensation to be received under the arrangement include:

  - All direct compensation to be received. This can be reported in total or by service.
  - All indirect compensation to be received. This disclosure should include a description of the service and the entity paying such compensation.
  - Any compensation received from an affiliate or subcontractor if set on a transaction basis, or charged directly against plan's investment and reflected in net value of investment.
  - Any compensation or refund due upon termination of the arrangement.
  - A description of the manner of receipt of such compensation: billed, deducted from participant accounts, paid from revenue-sharing funds, etc.

- Additional disclosures are required with respect to compensation paid to recordkeepers as part of a bundled service agreement. In such situation, the disclosure must include a description of all compensation to be received and a "good faith" estimate of the cost of the recordkeeping services. In providing such an estimate, they are to describe how they arrived at the estimate.

Similarly, additional disclosures are required with respect to designated investment alternatives made available by a recordkeeper or broker-covered service provider. These must include a description of:

- Any compensation (e.g., charges, fees, loads) that will be charged directly against amounts invested
- A description of annual operating expenses (e.g., expense ratio) if the return is not fixed
- A description of any other ongoing expenses (e.g., wrap fees, mortality and expense fees)

When must the disclosures be provided?

For existing arrangements, the disclosures must be made by July 1, 2012. For new arrangements, the disclosures must be made "reasonably in advance" of the effective date of the contract or arrangement. Disclosure must again be provided when the contract or arrangement is extended or renewed. If there is a change in any of the information required to be disclosed, other than investment-related information, the covered service provider must report such a change to the plan fiduciary as soon as practicable, but generally not later than 60 days after the covered service provider is informed of the change. The covered service provider must disclose changes in investment-related information at least annually.

How must the disclosures be provided?

The disclosures must be provided in writing. For this purpose, electronic communication is acceptable as long as such electronic information is readily accessible to plan management and they have received clear notification on how to gain such access.

The regulations do not specify a form for these disclosures. But the DOL has developed a *Sample Guide to Initial Disclosures* illustrating the fee disclosures for a bundled service provider. The sample is fairly short because it includes multiple links to information on the vendor's web page and cross-references existing service agreements. It is important to remember that upon receiving this information, plan management has to do more than file it away as "received." Plan management must now assess the provided information for "reasonableness."

How does plan management evaluate whether the arrangement is "reasonable"?

This is the tough part. If you look at the DOL *Sample Guide to Initial Disclosures*, you can see that the requirements do not require the covered service provider to provide a single figure or set of figures demonstrating the specific cost of each service for the contract term. More information will be provided, but it remains up to plan management to evaluate the total cost for each service, compare that cost to the marketplace and assess whether the fee being paid is reasonable for the services provided. This process does not require that all service providers be the lowest cost provider. Plan management must assess the quality of the services they receive with the cost, including the cost of change.

This is a complicated new standard. What if there is an error in our efforts to comply?

The government recognized that this is a lengthy and complicated new standard. As such, relief is granted as long as plan management can demonstrate they have made a good faith effort to comply. So what does that mean? Plan management needs to have a procedure in place to identify covered service providers and to solicit the required information. A procedure must also be in place to assess the information provided. Where there is a simple error in the information provided, no adverse consequences will arise as long as plan management obtains the corrected information within 30 days of the identification of the error. Where a covered service provide fails to provide required information or plan management does not believe they have provided sufficient information, plan management must have procedures in place to follow up with that service provider to obtain the required information. The covered service provider is to respond to any such requests within 90 days. To the extent the covered service provider fails to respond to such request, plan management must have procedures in place to assess the termination of the arrangement with such service provider and to notify the DOL of such failure.

What are the practical steps to implement this process?

Following are some steps plan management should consider with respect to the contracts with service providers:

1. Identify all service providers to the plan.
2. Distinguish "covered service providers" from other service providers.
3. Inform "covered service providers" of their status and inquire as to when you can expect to receive the required disclosures.
4. Institute a control procedure to confirm that all required disclosures have been received, reviewed for completeness and provided to plan fiduciaries for evaluation of the "reasonableness" of the contract.
    a. Review all service provider disclosures to ensure the required information has been received.
    b. Where information is missing or unclear, follow up in writing with the service provider.
    c. In the event of a failure to receive the required information, implement a procedure to follow-up with the supervisor of the person contacted in 4.b. above.
    d. If information is not received, notify the DOL and commence termination of the arrangement.

5. Develop a tool for estimating/accumulating the cost of each required service or investment based upon the information provided. It is likely that at this point plan management might conclude they do not have sufficient information. In such event, request in writing any additional information necessary to determine the estimated cost.
6. Analyze the disclosures and consider whether the fees charged are reasonable for the level of service desired. Consider the use of benchmarks, requests for proposal, engaging a professional services firm to conduct such inquiry, discuss fees with industry peers, etc.
7. Establish ongoing processes to monitor and analyze the annual fee disclosures or periodic revisions to demonstrate that the level of charges continues to be reasonable.
8. Document the review process and decisions made by the Plan Administrator or other fiduciary during the review.
9. Retain such documentation with other plan matters.

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