

## ERISA Service Provider Disclosures: What Plan Sponsors Need to Do Now

By Fred Reish, Joan Neri, Joshua Waldbeser, and Bruce Ashton

July 1 was a watershed date in the ERISA world. By that date, covered service providers to ERISA-governed retirement plans<sup>1</sup> had to provide written disclosures about their services, fiduciary status and compensation to the “responsible plan fiduciary” for all their existing plan clients. Failure to do so made their service arrangements prohibited transactions under ERISA.

We have passed that deadline, and the focus now shifts from the providers to plan sponsors.<sup>2</sup> So now what? This Bulletin describes the steps that plan sponsors must take to review the disclosures they received, and how to proceed appropriately in cases where the disclosures were not furnished. This is important because, if a plan sponsor fails to engage in a prudent process to evaluate disclosures provided by a service provider, or fails to identify required disclosures that are missing or deficient and take affirmative action, it will have engaged in a breach of fiduciary duty and, possibly, a prohibited transaction.

### Key Considerations for Plan Sponsors:

- > Required disclosures vary significantly depending on the services provided and the sources of the provider’s compensation; therefore, the plan sponsor may need to engage an attorney or consultant to evaluate the completeness of the disclosure.
- > If required information was not provided by July 1, 2012, specific procedures must be timely undertaken in order to avoid engaging in a fiduciary breach and, possibly, a prohibited transaction, and in some cases the arrangement may need to be terminated.
- > The plan sponsor must evaluate the disclosures and may need to renegotiate the contract or terminate it in order to avoid engaging in a fiduciary breach.

<sup>1</sup> Covered plans include both defined benefit and defined contribution plans, including ERISA-covered 403(b) plans; covered plans do not include governmental plans, non-electing church plans, IRAs or retirement plans that allow employers to contribute to IRAs set up for employees (referred to as SEPs or SIMPLEs).

<sup>2</sup> The disclosures under the final regulation must be made to the “responsible plan fiduciary,” defined as a fiduciary with the authority to cause a covered plan to enter into a service arrangement. While the responsible plan fiduciary is often an identified person or group, such as a plan committee, for ease of reference, we have elected to use the term “plan sponsor” to refer to the responsible plan fiduciary.

## Background

The final service provider disclosure regulation extended the compliance effective date from April 1, 2012 to July 1, 2012 and made certain other changes. (For information on the impact on plan sponsors of the prior “interim final” regulation, see our October 2011 bulletin at: <http://www.drinkerbiddle.com/Templates/media/files/publications/2011/service-provider-disclosures-the-impact-on-plan-sponsors.pdf>.)

The final regulation was issued under ERISA Section 408(b)(2), which provides an exemption for “reasonable” contracts and arrangements for plan services that would otherwise be prohibited transactions. The exemption is not new – plan fiduciaries have always had a duty to enter into “reasonable” service arrangements. What has changed is that the final regulation states that no contract or arrangement with a “covered” service provider will be reasonable unless the required disclosures are furnished. It also makes clear that a failure by the plan sponsor to take the actions prescribed by the regulation if the disclosure requirements are not satisfied will result in a fiduciary breach and, possibly, a prohibited transaction.

The disclosure must be made by “covered” service providers to the plan and must include detailed information about services, compensation and whether the provider is an ERISA fiduciary and/or an investment adviser registered under the Investment Advisers Act of 1940 or state law (an “RIA”). The disclosure is intended to provide plan sponsors with the information needed to make prudent judgments, as fiduciaries, as to the reasonableness of service arrangements.<sup>3</sup> Plan sponsors can also use the information to complete Schedule C of the Plan annual return (Form 5500), which generally requires plans that covered 100 or more participants at the beginning of the plan year to report information about all service providers that received \$5,000 or more in direct and indirect compensation during that year.

To fully appreciate the steps required of plan sponsors, it is important to understand how the prohibited transaction rule for services to a plan works under ERISA. First, the rule says a fiduciary cannot cause a plan to receive services from, or pay compensation to, a provider at all. However, Section 408(b)(2) provides an exemption from this prohibition so long as the arrangement is reasonable and the service provider receives no more than reasonable compensation. If all the mandatory disclosures are made and the arrangement is otherwise reasonable, the fiduciary is protected. But if the disclosures are not made and the fiduciary permits the plan to enter into or continue the arrangement with the service provider, the fiduciary has engaged in a breach of duty and a prohibited transaction.

<sup>3</sup> Note: More specifically, the disclosures are designed to provide responsible plan fiduciaries with information about (i) the services being provided, so the fiduciaries can determine whether they are necessary and appropriate; (ii) whether the provider is an ERISA fiduciary or RIA, and will therefore be held to a fiduciary standard under ERISA or securities laws; (iii) all the provider’s compensation, so the fiduciaries can determine whether it is reasonable in the aggregate (as opposed to only the fees paid directly by the plan or plan sponsor); and in some cases, (iv) conflicts of interest, so that they can be managed in a way to minimize any potential negative impact on plan participants and beneficiaries.

## What To Do Now

There are three steps plan sponsors should take now in preparation to review the disclosures:

- > Identify all covered service providers;
- > Determine what the disclosures should contain; and
- > If necessary, engage ERISA attorneys and/or consultants to assist in this process.

**Identify Covered Service Providers.** The disclosure requirements apply only to service providers that provide “covered services” to the plan. Generally speaking, “covered services” include:

- > Services provided as a fiduciary, either to the plan or to an investment vehicle that holds plan assets and in which the plan has a direct equity investment, or as an RIA;
- > Recordkeeping and brokerage services provided to participant-directed defined contribution plans, if one or more designated investment alternatives will be made available in connection with such services; and
- > Most other services provided to plans, but only if the provider receives “indirect compensation” – that is, compensation from sources other than the plan or plan sponsor.

There are many factors that must be taken into account in determining whether a service provider is covered by the final regulation. One challenge for plan sponsors will be determining which investment providers are fiduciaries. Under ERISA, mutual fund managers are not fiduciaries, but advisers and managers for other investment products (for example, collective trusts or hedge funds) may be, depending on the product, its investments, and how much of the investment in the product is from employee benefit plans. (Note that in the case of collective trusts, only plans may invest in them, so the trustee and advisers to the trusts will always be fiduciaries.) Likewise, it will be challenging to determine whether service providers are covered by reason of having received indirect compensation of which the plan sponsor may not be aware.

**Determine What the Disclosure Must Contain.** The information that must be furnished includes:

- > A description of the services provided;
- > Information regarding the covered service provider’s compensation, whether it is received directly from the plan or indirectly from a source other than the plan or plan sponsor (for example, from mutual funds, or their managers or affiliates); and
- > Whether the covered service provider is an ERISA fiduciary and/or an RIA for the plan.

The specific requirements on the information that must be furnished are even more complex than those governing covered service provider status. For example, additional disclosures are required with respect to indirect compensation, including descriptions

of the payor and the arrangement between the covered service provider and payor – the rationale being that plan sponsors may be unaware of indirect compensation payments, since they are not “billed” directly to the plan or sponsor. Understanding the “arrangement” with the payor will also help the fiduciaries understand and evaluate potential conflicts of interest. There are also several special rules that apply only to recordkeepers and certain investment providers.

***Engage Attorneys or Consultants to Assist.*** Plan Sponsors must be prepared to deal with the complexity of these requirements so as to avoid engaging in a fiduciary breach and a prohibited transaction. As indicated in the preamble to the final regulation, the Department of Labor does not consider ignorance of these disclosure rules to be a basis for relief from ERISA’s prohibited transaction rules:

“The Department does not believe that responsible plan fiduciaries should be entitled to relief...absent a reasonable belief that disclosures required to be provided to the covered plan are complete...Fiduciaries should be able to, at a minimum, compare the disclosures they receive from a covered service provider to the requirements of the regulation and form a reasonable belief that the required disclosures have been made.”

In order to fulfill this obligation, a plan sponsor should seek the assistance of legal counsel in understanding the scope and specifics of these requirements and should also seek the assistance of consultants who can assist in the evaluation process once the disclosures are obtained (discussed further below).

## What To Do Upon Receipt of the Disclosures

Upon receipt of the disclosures, plan sponsors should undertake the following action plan in order to avoid a fiduciary breach and engaging in a prohibited transaction:

- > Determine whether all disclosures from covered service providers have been made;
- > Evaluate the disclosures to determine whether they are complete;
- > If the disclosure is incomplete, carry out the steps necessary to obtain relief from the prohibited transaction rules (discussed below); and
- > Evaluate the disclosures to determine whether the arrangement is reasonable.

### ***Incomplete Disclosures - Obtaining Relief from the Prohibited Transaction Rules.***

Upon determining that a disclosure is incomplete – or if no disclosures are received from a covered service provider<sup>4</sup> -- the plan sponsor will not be deemed to be engaged in a prohibited transaction if:

<sup>4</sup> Keep in mind that some entities that provide services to a plan are not “covered service providers” – e.g., an entity providing third party administration services that receive only direct compensation from the plan. Therefore, the fact that a service entity fails to provide disclosures does not necessarily mean that it has violated the regulation, but this puts the plan sponsor on notice to find out. Also, all service providers, regardless of whether they are “covered,” are subject to ERISA Section 408(b)(2). Accordingly, while the disclosure requirements do not apply to “non-covered” providers, fiduciaries are well-advised to request similar disclosures to the extent necessary to ensure that the arrangements are reasonable and pay the providers no more than reasonable compensation.

- > The plan sponsor did not know that the service provider failed to make required disclosures and reasonably believed that it did disclose the required information. This condition may not be satisfied if no disclosures whatsoever were furnished.
- > The plan sponsor requests the missing information in writing upon discovering the failure. No explicit time limit is provided, but this should be done as soon as possible.
- > If the covered service provider does not provide the requested information within 90 days, the plan sponsor sends a written notice to the DOL. The final regulation describes the information that must be included in the notice and specifies that it must be filed within 30 days after (i) the covered service provider's refusal to supply the information or (ii) the end of the 90-day period, whichever is earlier. The DOL has provided a model form for this purpose on its website.
- > If the covered service provider does not provide the information promptly after the 90 day period, and the requested information relates to "future services," the plan sponsor terminates the arrangement as "expeditiously as possible" while still being prudent. In other words, the plan sponsor must act quickly, but should not terminate an arrangement in a manner that would harm plan participants. If the information is not provided within the 90 day period but does not relate to future services, the plan sponsor must make a prudent judgment as to whether the arrangement should be terminated. The preamble to the final regulation notes that fiduciaries are expected to take into account certain factors in making this decision, such as the nature of the failure and the availability and costs of a replacement service provider. It is not clear exactly what is meant by "future services," but plan sponsors should err on the side of caution. It may be reasonable to construe this term as not including discrete projects the provider has already undertaken, but an arrangement for ongoing services almost certainly cannot be maintained for a significant period of time if the disclosures are not furnished.

Also, sponsors of plans that are required to file Schedule C with their Form 5500, which are generally those that covered 100 or more participants at the beginning of the plan year, must request any information necessary to complete the Schedule C from a fiduciary or other provider that does not furnish it automatically. If the fiduciary or other provider still does not provide the necessary information, they must be reported on Schedule C as having failed to do so.

***Evaluate the Disclosures.*** Once the plan sponsor has the disclosure, the next step is to review it to determine whether the arrangement and compensation are reasonable, in accordance with ERISA's "prudent man" standard.

While the evaluation of the reasonableness of compensation may be undertaken without assistance, courts tend to agree that it is a "best practice" to work with a knowledgeable and independent adviser to assist in this process. Many plan sponsors use independent benchmarking services, and we recommend those that utilize "peer data" to determine whether compensation is reasonable in light of the services provided, as compared to other plans of similar size, type, and with like characteristics (It is critical that a plan's data be compared to data for an appropriate peer group. If the comparative data is

based on a benchmarking group that is not consistent with the characteristics of the sponsor's plan, the evaluation may be flawed and may not satisfy the prudence standard). A second option is using an RFP (Request for Proposal) process, but while effective, RFPs can be expensive and time-consuming. There are other options as well – in reviewing investment services and compensation, a knowledgeable consultant can help gauge if the plan's service agreements and compensation are supportable under industry standards.

The evaluation of the disclosure should take into account factors such as:

- > All sources of compensation – not just the fees paid directly by the plan or plan sponsor. For instance, revenue sharing from mutual funds and many other forms of compensation ultimately come from the plan, and typically are sourced, directly or indirectly, from the participants' investment returns;
- > Whether the services are appropriate for the plan and meet the needs of the participants;
- > Whether there are any conflicts of interest that have the potential to adversely affect the participants' best interests and if so, whether they are, or can be, managed appropriately;
- > For defined contribution plans, whether the investment-related information provided is adequate for the plan sponsor to comply with its own obligations under the participant disclosure rules; and
- > Whether the arrangement provides for termination on reasonably short notice and without penalty to the plan.

If a plan sponsor determines that an arrangement is not reasonable, the plan sponsor may have to terminate the arrangement. While the best interests of plan participants need to be taken into consideration in deciding whether to retain or terminate a service provider, an arrangement that is not reasonable cannot continue because it will be a prohibited transaction under ERISA.

Finally, the plan sponsor should document this process in evaluating the disclosure information and underlying contracts and arrangements, noting the reasons for each decision and any reliance on the advice of the attorneys and consultants. In the event of a DOL investigation (or litigation), the plan sponsor's fiduciary process is only as good as can be proved.

Plan sponsors should prepare for the challenges presented by the final 408(b)(2) disclosure regulation. Understand that avoiding prohibited transactions is only part of the equation – the plan sponsor's duty to exercise prudence extends to all plan service providers (even those not covered by the disclosure requirements). For this reason, the plan sponsor may wish to review all plan service arrangements with the same level of rigor as is required under the regulation.

## Employee Benefits & Executive Compensation Practice Group

If you have any questions about, or would like assistance with, any of the matters discussed in this bulletin, please contact any member of our Employee Benefits and Executive Compensation Practice Group listed below.

**Heather B. Abrigo**  
(310) 203-4054  
Heather.Abrigo@dbr.com

**Kathleen O'Connor Adams**  
(312) 569-1306  
Kathleen.Adams@dbr.com

**Gary D. Ammon**  
(215) 988-2981  
Gary.Ammon@dbr.com

**Bruce L. Ashton**  
(310) 203-4048  
Bruce.Ashton@dbr.com

**Pascal Benyamini**  
(310) 203-4050  
Pascal.Benyamini@dbr.com

**Mark M. Brown**  
(215) 988-2768  
Mark.Brown@dbr.com

**Bradford P. Campbell**  
(202) 230-5159  
Bradford.Campbell@dbr.com

**Summer Conley**  
(310) 203-4055  
Summer.Conley@dbr.com

**Barbara A. Cronin**  
(312) 569-1297  
Barbara.Cronin@dbr.com

**Joseph C. Faucher**  
(310) 203-4052  
Joe.Faucher@dbr.com

**Mona Ghude**  
(215) 988-1165  
Mona.Ghude@dbr.com

**Lindsay M. Goodman**  
(312) 569-1314  
Lindsay.Goodman@dbr.com

**Megan Glunz Horton**  
(312) 569-1322  
Megan.Horton@dbr.com

**Robert L. Jensen**  
(215) 988-2644  
Robert.Jensen@dbr.com

**Melissa R. Junge**  
(312) 569-1309  
Melissa.Junge@dbr.com

**Sharon L. Klingelsmith**  
(215) 988-2661  
Sharon.Klingelsmith@dbr.com

**Christine M. Kong**  
(212) 248-3152  
Christine.Kong@dbr.com

**David Levin**  
(202) 230-5181  
David.Levin@dbr.com

**Howard J. Levine**  
(312) 569-1304  
Howard.Levine@dbr.com

**Sarah Bassler Millar**  
(312) 569-1295  
Sarah.Millar@dbr.com

**Joan M. Neri**  
(973) 549-7393  
Joan.Neri@dbr.com

**Monica A. Novak**  
(312) 569-1298  
Monica.Novak@dbr.com

**Cristin M. Obsitnik**  
(312) 569-1303  
Cristin.Obsitnik@dbr.com

**Fred Reish**  
(310) 203-4047  
Fred.Reish@dbr.com

**Michael D. Rosenbaum**  
(312) 569-1308  
Michael.Rosenbaum@dbr.com

**Dawn E. Sellstrom**  
(312) 569-1324  
Dawn.Sellstrom@dbr.com

**Lori L. Shannon**  
(312) 569-1311  
Lori.Shannon@dbr.com

**Ryan C. Tzeng**  
(310) 203-4056  
Ryan.Tzeng@dbr.com

**Michael A. Vanic**  
(310) 203-4049  
Mike.Vanic@dbr.com

**Joshua J. Waldbeser**  
(312) 569-1317  
Joshua.Waldbeser@dbr.com

**David L. Wolfe**  
(312) 569-1313  
David.Wolfe@dbr.com