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Rule 408(b)(2): The New Fiduciary Paradox

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In June I asked a friend, a senior HR Professional, how his firm is handling the new fee disclosure rules taking effect on July 1st, 2012. His response, which I've since heard from many others, was, "Our 401(k) service provider is handling it all for us." Unfortunately for him, under the new rules that response constitutes a prohibited transaction under ERISA 406(a)(1)(c) – for which my friend can be held personally liable!

Many believe that the new Fee Disclosure Rules, 408(b)(2) & 404(a)(5), will provide a panacea for eliminating hidden or hard-to-find 401(k) fees. However, if plan sponsors do not actively engage in the fiduciary process, there will be an unintended consequence, one that may cost many plan sponsors dearly.

In a nutshell, what are these new rules?

First, it's important to understand that Rule 408(b)(2) is not new. What is new is the amendment to Rule 408(b)(2). Plan sponsors have always had the fiduciary duty to: understand all fees being paid by their plan; identify all compensation received by their service providers; and to ensure that those fees and compensation were reasonable relative to the services being provided. However, what Rule 408(b)(2) did not require was for service providers to disclose all of their fees and compensation the plan sponsor required in order to comply with Rule 408(b)(2).

The "fiduciary paradox" occurred when a plan sponsor attempted to fulfill the requirements of 408(b)(2), while their 401(k) service provider was under no legal obligation to disclose any or all of the fees and indirect compensation they received. Theoretically, the requirements of 408(b)(2) eliminate the fiduciary paradox.

Indirect compensation, sometimes known as "revenue sharing," is compensation paid by one service provider to another service provider of the same plan. In some cases, like the one described below, the service provider might use opaque or incomprehensible language within a contract or proposal, and thereby claim they made adequate disclosure. But in other cases the service provider might refuse to make any disclosure at all. For example, a response I once received was that "That is proprietary information. We have no obligation or desire to share it with anyone, including *you*."

The Department of Labor (DOL) intended the amended Rule 408(b)(2) and Rule 404(a)(5) to complement each other, with a goal of having service providers disclose all fees and compensation to both plan sponsors and plan participants. Among other requirements, 408(b)(2) requires "Covered Service Providers," or CSPs, to disclose all plan-level fees as well as all compensation received relative to the plan. The rule also requires plan sponsors to evaluate the reasonableness of those fees relative to the services provided, and to take action should those fees not be reasonable.

The Unintended Consequence

Simply put, with 408(b)(2), the Department of Labor forces plan sponsors to engage in the fiduciary process and identify unreasonable fees and compensation. In the event that plan sponsors fail to engage, 404(a)(5) will likely cause those savvy employees to do so. Plan sponsors should be prepared for complaints if employees believe they are paying too much. The DOL anticipates these complaints will put pressure on plan sponsors to replace CSPs that charge unreasonable fees.

Based upon the reasonable assumption that fee transparency will allow competitive market forces to drive 401(k) prices down, the Department of Labor has stated: "Over the ten-year period 2012-2021, the Department estimates that the present value of the benefits provided by the final rule [408(b)(2)]will be approximately $14.9 billion…"

While theoretically, the amended Rule 408(b)(2) eliminates the fiduciary paradox, in reality it creates an entirely new fiduciary paradox. Although common sense dictates that the DOL, or some state or federal agency, would be responsible to ensure that service providers comply with 408(b)(2), this is actually not the case. Under the new rule, it's the plan sponsor's responsibility to ensure that its CSP is complies with 408(b)(2)! Paradoxically, the hen must ask the fox if the chicks are safe.

The new fiduciary paradox lies in the fact that 408(b)(2) requires plan sponsors to ensure that the experts upon which they so often rely to comply with 401(k) requirements, are in fact complying with the new requirements of 408(b)(2). Particularly in the under $100 million market, plan sponsors rely heavily on the expertise, or purported expertise, of their CSPs in order to understand and fulfill their fiduciary responsibilities as a plan sponsor. According to Jeff Mamorsky, one of the original authors of ERISA, the "burden of having to reasonably believe that service providers disclosed the requisite information is of great concern." [emphasis added]

Mary Rosen, Associate Regional Director of the DOL's Employee Benefit Security Administration, in response to the question, "Can't a plan sponsor just rely on the CSP's disclosures?" replied that "The whole idea is to go through a prudent process and make sure that everything is reasonable." She concluded her response with, "So I guess a short answer to the question is no, a plan sponsor cannot rely on service providers." There are a limited number of ways for the plan sponsor to act prudently.:

a. If the CSP fails to provide any disclosure, provides incomplete disclosure, or if additional information is needed to determine compliance with 408(b)(2), the plan sponsor must demand it from the CSP.

b. If the CSP fails to provide this information within 90 days of the request, the plan sponsor must report the CSP to the Department of Labor. According to nationally recognized ERISA attorney Fred Reish, plan sponsors must also "fire their advisors if they fail to provide information regarding fees and information about their 401(k) plan within 90 days of a written request."

c. If a plan sponsor fails to evaluate the disclosures, fails to identify unreasonable compensation in a disclosure, or fails to take the required actions in the scenarios above, the plan sponsor will be liable for having participated in a prohibited transaction– for which the penalties and fines can be significant, and for which the plan sponsor can be held personally liable.

While it might appear that many plan sponsors will be caught in this new fiduciary paradox, there is, and always has been, one ace-in-the-hole available to every plan sponsor – a prudent process. As stringent as ERISA can be, the courts have typically protected fiduciaries so long as they adhered to a well-documented, prudent process in making decisions. Even 408(b)(2) provides an exemption for a plan sponsor in the event that he or she was not aware of any failure by a CSP and reasonably believed that proper disclosures were made. It is unlikely that a court would accept a "reasonable belief" argument without documentation of the prudent process the plan sponsor used in reaching reasonable belief.

While some plan sponsors might find all of this tedious and overwhelming, there are options. ERISA not only allows, but suggests that "Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert." Plan sponsors must be cautious of "phantom fiduciaries" when engaging qualified independent experts. Phantom fiduciaries are typically 401k salespeople whose employers claim to offer fiduciary expertise and assistance, but often deny any sort of fiduciary responsibility in the mouseprint of their contracts and marketing material.

Conclusion

The new fee disclosure rules are imperfect, but still a step in the right direction. The bottom line for plan sponsors is the same now as it has always been: "For the fiduciary that has established a documented process of fiduciary prudence, litigation is an inconvenient and costly way to prove adherence to ERISA's fiduciary standards of care. However, for fiduciaries that have been remiss in their fiduciary duties the courtroom becomes the forum for exposure and judgment."

This article has been substantially abbreviated. For the full article, including references, please see: www.PrudentChampion.com

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