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The 408(b)(2) Trap for Plan Sponsors

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Plan sponsors, and their officers who make 401(k) decisions, face lawsuits and penalties if they do not take steps to comply with new regulatory requirements.

The Department of Labor's (DOL) 408(b)(2) regulation imposes two significant duties on plan sponsors. This article describes the two duties and generally discusses the steps that must be taken to comply with the regulation. A more detailed discussion can be found in the Drinker Biddle bulletin "ERISA Service Provider Disclosures: What Plan Sponsors Need To Do Now" at *www.cefex.org/downloads/reish_spd_bulletin_cefex.pdf*

All 401(k) plan "covered" service providers must have given "responsible plan fiduciaries" (that is, the officers or committee members who make decisions about 401(k) plans) written disclosures of services, compensation and status by July 1, 2012. That includes recordkeepers, advisers, and other providers (such as many third party administrators and investment managers). To make this article easy to read and understand—even though it is about a technical subject—I assume that the reader is a responsible plan fiduciary for a 401(k) plan. So, this is about your legal responsibilities.

The first requirement is that you must make sure that you received all of the required disclosures. Then, you need to read the disclosures to make sure they are complete. Unfortunately, without knowing who is a "covered" service provider and what needs to be disclosed, it is almost impossible for you–or other plan decision-makers–to do that job.

But, you must. If you fail to review the materials and determine their adequacy within a reasonable period of time—and it turns out that some of the disclosures were missing, you committed a prohibited transaction under both ERISA and the Internal Revenue Code... subjecting yourself to penalties and possible damages.

As a practical matter, if you don't know what a "covered" service provider is, you need expert advice. That advice can come from an ERISA attorney or a qualified consultant. Or, you can just assume that everyone who provides advice, investments, reports, documents or other services to your plan is a covered service provider and insist that they give you the mandated disclosures.

But, even then, how will you know if the disclosures are adequate? The regulation requires that the advisers and providers describe their services—and perhaps you can tell if the description is adequate, for example, does it list the services that your plan is actually receiving? However, there are more requirements. The disclosure of "status" must tell you if the service provider is a registered investment adviser (RIA) and an ERISA fiduciary. How can you tell if the disclosure is correct? Finally, the disclosure must tell you about all the compensation the service provider or its affiliates are receiving, directly or indirectly, because of the services provided to your plan. For example, your adviser may be receiving payments from the 401(k) investments or other providers that are "behind the scenes." How can you know if the disclosures include those payments?

But, you must. The DOL explained its position in the introduction to the regulation:

"The Department believes that plan fiduciaries need this information, when selecting and monitoring service providers, to satisfy their fiduciary obligations under ERISA section 404(a)(1) to act prudently and solely in the interest of the plan's participants . . . ."

Also, the regulation requires that the compensation disclosures be specific enough that you can evaluate the compensation and make a decision that it is reasonable. The regulation is clear on that point . . . it says:

"Any description . . . must contain sufficient information to permit evaluation of the reasonableness of the compensation. . . ."

How can you tell if the disclosure meets that test?

The 408(b)(2) regulation requires that you review the disclosures–and then make a written request to the service provider for any missing information. If the provider refuses to give you the information, or fails to do so within 90 days, you must fire the service provider and file a report with the Department of Labor. The failure to take those steps is a prohibited transaction . . . and could expose you to personal liability, taxes and penalties.

Since it is difficult to confidently navigate that process—or even to understand what needs to be done—the best approach is to get help.

In fact, in the introduction to the regulation, the DOL makes that recommendation:

"This regulation requires that responsible plan fiduciaries receive the basic information needed to make informed decisions about service costs and potential conflicts of interest. If responsible plan fiduciaries need assistance in understanding any information furnished by the service provider, as a matter of prudence, they should request assistance, either from the service provider or elsewhere."

Your second duty is to evaluate the disclosures. As explained by the DOL in the introduction to the regulation:

"ERISA section 404(a) also obligates plan fiduciaries to obtain and carefully consider information necessary to assess the services to be provided to the plan, the reasonableness of the compensation being paid for such services, and potential conflicts of interest that might affect the quality of the provided services."

The failure to take this step is a fiduciary breach.

To do that evaluation, you must engage in a "prudent process". That means that you need to:

- Gather the "relevant" information;
- Compare it to valid marketplace information (generally, that means information about plans with similar amounts of assets and numbers of participants);
- Consider the quantity, quality and nature of the services; and
- Make an informed and reasoned decision about issues such as reasonableness of compensation of the provider, adequacy of services and conflicts of interest.

Since most plan sponsors do not have the experience or information needed to do this job, you should turn to knowledgeable and qualified consultants for help. Those consultants have access to benchmarking information that you need to determine if the compensation of your service providers is reasonable.

In addition, there are services that are available to review the steps that you take and to comment on the adequacy of those steps. In other words, consultants can evaluate the steps you have taken and, if those steps satisfy the law, they can provide you with an opinion to that effect. That process and opinion can provide valuable protection if you are challenged by the Department of Labor or an attorney.

The failure to evaluate the compensation, conflicts, and services is a fiduciary breach. If it results in losses to participants–for example, it turns out that, unknown to you, a provider is making too much money from your plan or its investments–you, and the other 401(k) decision-makers at your firm, can be personally liable for those losses.

Some plan sponsors will undoubtedly expose themselves to these risks—perhaps through a lack of knowledge of the requirements or due to a failure to understand the risks. That is unfortunate. This is an area where, with qualified help, a plan sponsor . . . you . . . can eliminate the risk. There are enough legal traps and pitfalls with taking unnecessary risks.

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