ERISA § 408(b)(2)—The Deadline Has Passed but There Is More Work Ahead

By David J. Witz
and Thomas E. Clark, Jr.

The collective response to the ERISA Section 408(b)(2) regulations has been underwhelming. It has been reported that both plan sponsors and service providers have done the bare minimum, if that, in complying. This article makes clear that there is more than meets the eye when it comes to the ERISA Section 408(b)(2) regulations and ignoring them can come at a great risk.

David J. Witz, AIF®, GFS™ is the CEO/Managing Director, and **Thomas E. Clark, Jr., J.D., LL.M.** is the CCO/Director of Fiduciary Oversight, for Fiduciary Risk Assessment (FRA). FRA provides consulting, white papers, expert witness services, financial and criminal background checks of advisors and advisor RFP services. PlanTools™, a wholly-owned subsidiary, delivers web-based expense analysis, benchmarking, 408(b)(2) reporting, revenue-sharing database, standards-based risk management, and fiduciary governance solutions. For more information about FRA/PlanTools contact David J. Witz at 704-564-0482 or *dwitz@fraplantools.com,* or Thomas E. Clark, Jr. at 704-247-7968 or *tclark@fraplantools.com.*

Attitude Is Everything

Have you heard these claims?

> "ERISA § 408(b)(2) was last year's compliance issue."
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> "Advisors and service providers take care of 408(b)(2) for me."
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> "Only large retirement plans get scrutinized by the government regarding costs and fees."

According to industry sources and our own research, these are the most prevalent attitudes toward ERISA Section 408(b)(2). However, nothing could be farther from the truth. Few people understand that much of the "new" requirements for reviewing and approving fees under ERISA Section 408(b)(2) have always been expected of plan sponsors and fiduciaries; however, the Department of Labor (DOL) previously had no direct means by which to require that service providers give sponsors the information they need for this process. The regulations under ERISA Section 408(b)(2) have eliminated this hurdle and the DOL and the courts stand ready to enforce compliance for plans of all sizes. The future is perilous for those that fail to understand these new realities. If the plan sponsor is unable to competently complete the due diligence necessary to satisfy the ERISA Section 408(b)(2) requirements, a service provider should be retained that can perform the necessary assessment and document the process to support a claim of procedural prudence.

The DOL

The DOL is the government department responsible for enforcing the Employee Retirement Income Security Act (ERISA). In particular, the DOL is tenacious in defending the rights of participants, especially when a prohibited transaction is involved. In fact, it is not beyond the DOL to join forces with plaintiff attorneys when participants are victims of fiduciary malfeasance.

To protect participants, Congress enacts legislation and the DOL issues regulations to ensure that participants' interests are secure. On February 3, 2012, the Employee Benefits Security Administration (EBSA)—the agency of the DOL responsible for retirement plans—published a final regulation governing service provider fee disclosures that are required for a service contract or arrangement to be reasonable. The regulation was effective on July 1, 2012, and it requires all covered service providers (CSP) [29 C.F.R. § 2550.408b-2(c)(1)(iii)] to disclose certain information to a responsible plan fiduciary (RPF) [29 C.F.R. § 2550.408b-2(c)(1)(viii)(E)] about the services provided for compensation received, including indirect compensation from sources other than the plan and non-monetary compensation. The DOL has determined this information is needed by the RPF to be able to understand the services, assess the reasonableness of the compensation (direct and indirect) received by a CSP, their affiliate, or a subcontractor, and identify any conflicts of interest that may impact the CSP's performance. [77 Fed. Reg. 5633 (Feb. 3, 2012)] According to the Preamble to the final regulation, an RPF is encouraged to broadly interpret and apply the disclosure requirements to all service provider relationships with the plan to obtain comprehensive information before making a decision. [77 Fed. Reg. 5634 (Feb. 3, 2012)] It also is important to emphasize that compliance with ERISA Section 408(b)(2) is independent of other fiduciary obligations found in ERISA. [Labor Reg. § 2550.408b-2(c)(1)(i)]

Failure to comply with ERISA Section 408(b)(2) can result in the imposition of significant penalties under the Internal Revenue Code (Code) and ERISA in addition to the disgorgement of unreasonable fees. The Code imposes a two-tiered excise tax as follows:

1. A first tier excise tax equal to 15 percent of the amount involved for each year or partial year the prohibited transaction remains uncorrected, and
2. A second tier excise tax equal to 100 percent of the amount involved if not corrected within 90 days of an agency order.

ERISA's civil penalty under ERISA Section 502(l) is 20 percent of the "applicable recovery amount" paid pursuant to any settlement agreement or court order. However, this penalty could be offset by the penalties paid under the Code.

A failure to comply that could trigger a penalty and/or excise tax can occur if the CSP:

1. FAILS to provide complete disclosures,
2. Receives payment for services it FAILS to deliver, or
3. Receives compensation that FAILS to be reasonable.

Plan Sponsor Must Receive Complete Disclosures

According to the Preamble to the final ERISA Section 408(b)(2) regulation,

> The Department *does not believe* that responsible plan fiduciaries should be entitled to *relief* provided by the class exemption *absent a reasonable belief* that *disclosures* required to be provided to the covered plan *are complete*. To this end, responsible plan *fiduciaries should* appropriately *review* the disclosures made by covered service providers. 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*. [77 Fed. Reg. 5647-48 (Feb. 3, 2012) (emphasis added)]

Bottom line, too few plan sponsors are equipped to engage in the necessary self-assessment process to secure the exemption under a "reasonable belief" standard and, unfortunately, too few plan sponsors are even aware this standard exists. As a result, it is anticipated that a plan sponsor will, in ignorance, believe it has received complete disclosures without validating the belief. No documented assessment: no proof. No proof: no exemption. No exemption: big penalties and a target rich environment for DOL auditors and plaintiff attorneys.

Plans Must Receive Contracted Services

All CSPs must be hired and monitored with an eye focused on procedural prudence. This obligation does not apply just to the selection of investments; it applies to ALL CSPs paid from plan assets, including the custodian, trustee, recordkeeper, third-party administrator, investment advisor or manager, auditor, and attorney.

The selection of any service provider must be subject to a thoughtful, documented process. Thereafter, the RPF must monitor the provider's performance to confirm and validate that the selection was prudent and continues to be in the best interests of the participants. In other words, trust but verify. For example, once you select an investment alternative, you monitor the investment to confirm it continues to be a prudent offering. In the same way, you must review the services rendered by each service provider and confirm the services promised have been delivered subject to the quality standards expected.

Service providers that over-promise and under-deliver cause the plan to pay an unreasonable fee. Blindly accepting the sales pitch without engaging in a periodic review of deliverables is a sure-fire way to create liability for the RPF. By analogy, would you buy a car that provides a service warranty that covered services at the discretion of the car dealer? Of course not, because it is not prudent to pay for something you do not receive. However, ERISA fiduciaries are held to the highest fiduciary standards known to law…standards that impose personal liability. As a result, paying a CSP for services not rendered is unreasonable, imprudent, and prohibited. In short, it is a recipe for monetary damages, penalties, and excise taxes, and the collateral to make good on the damages is the RPF's personal assets.

With so much at stake, industry insiders expect this to become an area of focus for the DOL and plaintiff attorneys because paying for services that are not delivered is the equivalent of paying an unreasonable fee.

Plan sponsors must make sure the service contract is written with precise clarity as to the fees charged for services rendered. Contracts that state "the following fees charged *may* or *could* cover any of the following services" should be avoided. Such wording is designed to protect the CSP not the RPF, the plan, or the participants. In addition, the RPF must confirm the service agreement does not suggest or imply that settlor services or unnecessary services are paid from plan assets.

The risk is too great for a plan sponsor to blindly rely on their CSP disclosures as being per se complete. Instead, it is prudent to implement a documented monitoring process to ensure the disclosures are complete so as to avoid payment of monetary damages equal to the total of all fees paid to the CSP plus lost opportunity cost and any applicable penalties or excise taxes.

Plans Must Pay Only Reasonable Fees

In order to avoid a prohibited transaction, fees paid by a plan must be reasonable. It is not permissible to pay unreasonable fees to any service providers directly or indirectly from plan assets. To avoid this claim you must establish that fees are reasonable. This can be accomplished by either:

1. Conducting a formal request for proposal (RFP),
2. Conducting a formal request for information (RFI), or
3. Benchmarking fees.

Assuming an objective process is adopted, any of these options provide the necessary documentation to draw an acceptable conclusion, although, the cost, time, and effort can be substantially different. That said, this list is organized in order of descending cost and time requirements, with benchmarking being the least costly and time consuming, to RFPs being the most.

Plan Sponsors Must Hire Qualified Service Providers

If you are happy with your current service providers or you recently retained a service provider such that an RFP or RFI does not make sense, the plan sponsor's best proof of due diligence is a benchmarking study. Of course, this assumes the plan sponsor qualified the service provider as an expert for the engagement before they were retained.

Unfortunately, it is rare that an employer conducts a thorough background check on their service providers, especially the plan's investment advisor, who is typically the RPF's "service quarterback." An advisor should be selected after conducting a comprehensive RFP that evaluates the knowledge, skill, education, staffing, reputation, capabilities, characteristics, and reasonableness of fees according to courtroom standards. Thereafter, the plan sponsor must default to monitoring the advisor's activities and periodically confirming fees remain reasonable.

Your advisor may look good but it does not mean he or she is qualified. Unfortunately, the requirements to become an investment advisor are minimal. In fact, in the state of North Carolina, the educational and training standards required to certify a hair-stylist are higher than those applicable to an advisor managing billions of dollars. As a result, many plan sponsors have retained an advisor with minimal skills when the obligation is to retain an expert where the plan sponsor's expertise is lacking.

It is worth noting that, if a plan sponsor is targeted for litigation, its expertise and that of its service providers are subject to scrutiny. Courtroom procedures for determining expertise are quite different and more intensive than most screening processes implemented during the typical selection process. It is, therefore, imperative that a fiduciary be able to defend the selection of their service provider based on its expertise and not on its entertainment value, for example, golf score.

Audit Reports May Influence Litigation

The audit season for plan years ending December 31, 2012, was the summer of 2013. This audit season was the first time for many auditors to address ERISA Section 408(b)(2) compliance. Because of the increased risk of litigation, it behooves the RPF to ask its auditor the following questions before future audits begin:

1. How many employee benefit (EB) plan audits do you personally perform and how many does your firm perform?

2. How many years have you and your firm performed EB audits?
3. What percentage of your time do you spend annually performing EB audits?
4. What percentage or your firm's gross audit revenues are derived from qualified plan audits?
5. Are you a member of the AICPA Employee Benefit Plan Audit Quality Center?
6. Do you obtain continuing education annually with the AICPA EBP program or state society that is specific to EB audits?
7. Do you attend the AICPA ERISA conference annually?
8. Has any plan that your firm audited been the subject of an adverse DOL audit or other regulatory complaint?
9. Does your firm act in a consulting manner for any EB plans? Will you act in a consulting manner on behalf of our plan?
10. What is your audit process for determining ERISA Section 408(b)(2) compliance? Are you willing to opine that our plan is in compliance?

It is important for an RPF to ensure that the auditor it retains has the EB expertise needed to maximize risk mitigation strategies. An auditor that is intimately familiar with ERISA Section 408(b)(2) will be able to add a great deal of value to the audit engagement. However, an auditor that dabbles in EB audits is a high risk engagement that may inadvertently create more liability for a plan sponsor. This should come as no surprise based on industry statistics that suggest the vast majority of auditors that perform ERISA audits have very few EB clients, thus, very little EB audit experience. According to a presentation at the annual ISCEBS 2010 conference by Gallina LLP, a CPA firm that conducts employee benefit audits:

1. Approximately 76,000 plan audits are conducted each year;
2. 25,000 audits are performed by 64 public accounting firms that audit 100+ plans or more;
3. 51,000 audits are conducted by nearly 10,000 different public accounting firms; and
4. Of those 10,000 firms, 8,000 perform *five or fewer audits*.

Unfortunately, many plan sponsors see no meaningful value to a plan audit. In fact, many auditors legitimately complain that a plan sponsor will move the audit engagement from one auditing firm to another for a nominal cost savings. This may change with the advent of the ERISA Section 408(b)(2) fee disclosure obligations where a knowledgeable auditor can provide information regarding those disclosure obligations.

It is important to remember that an auditor MUST report a prohibited transaction (PT) regardless of the materiality. In other words, any PT must be reported or included in the management report filed with the DOL. An ERISA Section 408(b)(2) PT is an actionable event for the DOL and any plaintiff attorney that discovers it before the DOL acts. Remember, once the Form 5500 and audit report are filed with the DOL, they become public documents that are searchable by anyone on the DOL's Web site.

To mitigate risk this year and in the future, a plan sponsor should seek the auditor's advice on how best to address ERISA Section 408(b)(2) so that no red flags catch the attention of the DOL once the Form 5500 and attachments are filed. It is a prudent step for the RPF to review the audit report with the auditor and to seek the opinion of the auditor as to action steps the RPF should take to ensure compliance obligations are met with ERISA Section 408(b)(2). While this step may increase audit costs, it is time and money well spent if your auditor can provide you with objective information that will help you avoid attracting unwanted attention from the DOL or plaintiff bar.

If your auditor is unwilling to assist you in your compliance efforts with ERISA Section 408(b)(2), then seek the services of a qualified advisor, attorney, CPA, or consultant that can conduct the ERISA Section 408(b)(2) assessment before the audit report is finalized. This recommendation cannot be over-stressed.

How to Ensure ERISA Section 408(b)(2) Compliance

There are four alternatives to assist a plan sponsor in meeting the requirements of ERISA Section 408(b)(2). First, if the plan sponsor already has an ERISA Section 408(b)(2) due diligence process in place, obtain a comprehensive fee benchmarking study to assist with documenting the determination of fee reasonableness for services rendered. Providing the auditor with a benchmarking report and your conclusions will assist the auditor with writing a positive qualified opinion. This, in turn, will minimize the likelihood of your plan being targeted by the DOL for audit.

Second, engage in a step-by-step process to conduct an ERISA Section 408(b)(2) compliance self-assessment. For those individuals who wish to "do it themselves," the challenge will be to develop a comprehensive checklist of questions tied to the regulatory requirements. This option makes sense only if the plan sponsor has the internal expertise to take on this level of analysis.

The third possibility is to conduct a formal search for a professional advisor or consultant that has the expertise to assist you in conducting ERISA Section 408(b)(2) analysis. The formal search process should ensure that you are choosing someone that has the necessary expertise to do the job. If the retained advisor will also be providing investment advice related to a plan's lineup, then finding the right advisor for your plan is critical to successfully achieving the objectives and results you expect. Conducting a formal search can be achieved on your own, with the help of an independent consultant, and/or using a technology-based solution. It also is recommended that you document your process and include a financial and criminal background check of the advisor.

The fourth option is to retain the services of an experienced ERISA attorney. Keep in mind that ERISA attorneys can have a focus on health and welfare plans, nonqualified deferred compensation programs, and various aspects of qualified plans. What you need is an ERISA attorney that is intimately involved with retirement plan design, qualification, and compliance issues. You also want to establish your expectation that your advisor, if you have retained one, and attorney work together when appropriate. It takes a village to manage a successful retirement plan and your attorney and advisor are two key components of a successful outcome.

Conclusion

ERISA Section 408(b)(2) has increased retirement plan costs and litigation risk especially for plans subject to an audit. However, the increased cost for ERISA Section 408(b)(2) due diligence assessments and retention of qualified experts will be outweighed by the benefits of risk mitigation. The best line of defense is a well-documented procedural and substantive prudent fiduciary review. If the plan sponsor does not have the expertise internally to implement, conduct, and monitor the ERISA Section 408(b)(2) compliance process, then the RPF should retain the services of an expert. Failure to comply with ERISA Section 408(b)(2) is a prohibited transaction that can result in significant penalties and excise tax. The liability is too great to assume everything is ok. Validation of compliance is the only method to reduce risk and avoid liability. In short, the ERISA Section 408(b)(2) code of conduct is "trust, but verify." ■