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Section 408(b)(2) Proposed Regulations and ERISA's General Fiduciary Obligations

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Introduction. Proposed regulations revising Section 408(b)(2) of the Employee Retirement Income Security Act are designed to redefine what constitutes a reasonable contract or arrangement. When finalized, the regulation will provide a statutory exemption for a prohibited transaction claimed under ERISA § 406(a)(1)(C). It will not provide a statutory exemption for any prohibited transaction asserted under ERISA § 406(b) or any other part of § 406(a). Furthermore, the revisions to § 408(b)(2) do not preempt any of the general fiduciary responsibilities under ERISA § 404. In fact, the Preamble to the proposed regulation specifically emphasizes the requirement to comply with ERISA's fiduciary duties irrespective of the proposed regulation. The proposed regulations serve to clarify the meaning of a reasonable contract or arrangement; they are not intended to replace or redefine the existing statutory or regulatory framework for evaluating the conduct of a fiduciary under the general fiduciary rules.

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Currently, the regulation at 29 CFR § 2550.408b-2(c) states only that a contract or arrangement is not "reasonable" unless it can be terminated without penalty on reasonably short notice. The Department of Labor proposes to add that in order for a contract or arrangement for services to be reasonable, "it *must require* that certain *information be disclosed* by the service provider to the responsible plan fiduciary." (Emphasis added).[1] The disclosure imposed by § 408(b)(2) requires a service provider to provide the plan sponsor with a full disclosure of fees charged by services rendered with a description of any conflicts of interest in writing. Failure to comply with the written disclosure requirement creates a prohibited transaction under ERISA § 406(a)(1)(C) and subjects the service provider to potential legal and equitable remedies. Although the same remedies may be imposed against the plan sponsor for failure to comply with § 408(b)(2), it is likely the plan sponsor will qualify for a separate prohibited transaction exemption that exonerates the plan sponsor if the prohibited transaction occurred without its knowledge.

The preamble to the proposed changes discusses several strategies that the DOL considered, and provides insight into its process of evaluating alternative methods for addressing current deficiencies in disclosure. One of the alternatives DOL considered was to "remain with the status quo." As the DOL acknowledged, the current regulatory framework imposed by ERISA § 404 and § 408(b)(2) "*already require* plan fiduciaries to ensure that fees paid to service providers are reasonable." (Emphasis added).[2] According to the fiduciary duty prescribed under the current regulatory framework, a fiduciary "must obtain information about fees and conflicts

[1] 29 CFR § 2550.408b-2(c).
[2] 72 Fed. Reg. 70995 (December 13, 2007).

of interest."[3] In addition to the existing general fiduciary duties that require fiduciaries to pay no more than reasonable expenses for services rendered, the DOL has issued technical guidance in the past concerning a plan fiduciary's obligation "to assess all compensation received by service providers."[4] In spite of a consistently clear ERISA mandate to obtain full disclosure of "all" compensation, fiduciaries have typically operated in ignorance of the actual amount of fees paid for services rendered when those fees are paid from plan assets.

Unfortunately, fiduciary ignorance has been spawned by a climate of obfuscation. Service providers aggressively competing for a bigger slice of $2.5 trillion in retirement plan assets have creatively camouflaged plan expenses in asset-based fees with a plethora of descriptive terms created to describe the fee without disclosing the amount or the reason for the expense. In essence, service providers have leveraged every loophole that can be leveraged to protect their ability to offer what appears to be a "free" or low cost retirement plan solution. In truth, in the context of the retirement industry, "free" might well be defined as "a methodology to transfer the entire cost of services to trust beneficiaries without fully disclosing the parties who benefit, the amount they receive, the services they render, or the conflicts of interest in which they participate." The implications that can be drawn from this definition are clearly disparate from the duty of loyalty that requires a fiduciary to act in the best interest of the plan participants.

In short, the DOL correctly assessed the situation and came to the right conclusion. Additional regulations are appropriate in an environment where few fiduciaries have demanded a full disclosure of fees charged for services rendered or disclosure of any conflicts of interest. Without a more detailed regulatory framework which explicitly details the obligations of both fiduciaries and service providers, the gap is appropriately filled by the judiciary. The existing regulatory framework was designed to encourage participants to police their benefits and enforce their rights. Enforcement is supported by an active but overburdened DOL and a plaintiff's bar eager to assert the rights of participants. Although the proposed regulations offer hope for the future integrity of the retirement system, it may not be sufficient to secure what was intended from ERISA's inception. The proposed regulations suggest that DOL may underestimate the creativity of an industry accustomed to unquestioned fees and charges assessed to plan assets of participants and plan sponsors. Regulating this industry is no small task. The proposed regulations are a good first step, but much more is needed to protect the participants and restore faith in the retirement system.

The DOL also considered adopting a "general regulatory framework" to correct existing fiduciary deficiencies, but did not select this alternative since it would not specify explicit requirements of disclosure. According to the DOL, under this approach, "parties may be left with ongoing ambiguity about exactly what information is necessary to fully evaluate a service provider contract or arrangement."[5] Unfortunately, this DOL comment tactfully covers the past nonfeasance of plan fiduciaries. There is no excuse for a fiduciary to act in any manner other than in the best interests of the plan participants as required by ERISA § 404. Therefore, the willingness of a fiduciary to engage a service provider of any type without requesting a full disclosure of all revenues, tying those revenues to specific services to determine whether the services are necessary and fees are reasonable, and confirming that no conflicts of interest have occurred, would appear to violate a basic fiduciary obligation that should not require further guidance or clarification.

The Preamble reveals that the DOL rejected a "broad application" approach to all service arrangements that rely on the § 408(b)(2) service provider exemption for relief from ERISA's prohibited transaction rules. According to the DOL, broad applicability would include service arrangements that do not involve complex compensation arrangements or conflicts of interest. Although little space was dedicated to revealing the DOL's reasoning on this issue, a broad regulatory application is easily dismissed if the intent of the proposed regulation was to exclusively guide the behavior of service providers who are compensated either directly or indirectly from plan assets.

DOL's New Approach. The DOL reveals its reasons for developing a "specific framework with limited application" as its preferred approach for legislating fiduciary behavior: "The Department believes this framework will yield the information that plan fiduciaries need in order to assess the reasonableness of compensation paid for service from these service providers. Absent the regulation, such information may be difficult to obtain."[6] Note that the DOL's preferred approach does not state that the information is not presently available—just that it is difficult to obtain. Nor does it state that the information fiduciaries need to assess reasonableness was not required in the past. Both these points become clear as the Preamble is perused for DOL references to existing fiduciary requirements. For instance, consider the following examples:

"Fundamental to a fiduciary's ability to discharge these obligations (i.e., to act prudently and solely in the interest of the plan's participants for the exclusive purpose of providing benefits and defraying reasonable expenses) is the availability of information sufficient to enable the fiduciary to make informed decisions about the services, the costs, and the service providers." [72 Fed. Reg. 70,988]

The proposed modifications to § 408(b)(2) impose an explicit obligation on the service provider to disclose information to the plan fiduciary who has always had an explicit obligation to obtain this information in the past. However, if the service provider is a fiduciary (by choice or determined functionally) it too had an obligation in the past to divulge all information that § 408(b)(2) now requires. In short, the § 408(b)(2) modifications now spotlight the past failures of plan fiduciaries and service provider fiduciaries (acknowledged or functional) who failed to act in the best interests of plan participants.

"Although the Department has issued technical guidance and compliance assistance materials relating to the selection and monitoring of service providers, the

[3] *Id.*
[4] *Id.*
[5] *Id.*

[6] 72 Fed. Reg. 70,996 (Dec. 13, 2007)

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Department nevertheless believes that, given plan fiduciaries' need for complete and accurate information about compensation and revenue sharing both plan fiduciaries and service providers would benefit from regulatory guidance in this area.'' [72 Fed. Reg. 70,988]

Section 408(b)(2) sets a new standard of disclosure and adds a consequence for failing to disclose fees and conflicts of interest in writing. In the past, a specific written disclosure of fees charged by services provided was not explicitly required under the statutory provisions of ERISA, although it might be argued that § 402(b)(4) implicitly required the plan document to include a sufficient description of how fees were paid from plan assets so that participants could police their benefits and enforce their rights. While it is arguably imprudent to engage a service provider without a written contract that specifically describes the fees by services rendered and divulges any potential conflicts of interest, there is no specific reference to a section of ERISA, regulation, or Supreme Court decision on which to base a claim that service agreements must be in writing. At best, the current environment refers to disclosure of payments made from the plan in § 402(b)(4), and a single case from the Tenth Circuit holds that § 406(a)(1)(C) was violated absent a written contract for services between a plan and a party in interest where evidence failed to support a finding that the services were necessary to the plan and for reasonable compensation.[7]

The determination of whether services are necessary or the fees paid for those services are reasonable is not defined by the existence of a written contract but by the applicable facts and circumstances. However, unless he has a photographic memory with explicit recall of all details, it is possible that a fiduciary who failed to engage a service provider with a written contract has invited a claim of fiduciary breach under the exclusive benefit obligations of § 404(a)(1)(A). In essence, a fiduciary has always had the obligation to elicit the necessary information to make an informed decision; what has changed is the obligation of nonfiduciary service providers to provide written disclosure of their fees by services rendered and to identify any potential conflicts of interest. Should the proposed changes become effective, the outstanding questions are, first, whether the new consequence is sufficient to effect a change in behavior, and second, whether plaintiffs' attorneys will recognize the window of opportunity they have to represent plan participants who claim damage as a result of plan sponsors' and service provider fiduciaries' failure to adhere to a fiduciary's duty of loyalty.

''The Department believes that in order to satisfy their ERISA obligation, plan fiduciaries need information concerning all compensation to be received by the services provider and any conflicts of interest that may adversely affect the service providers' performance under the contract or arrangement.'' [72 Fed. Reg. 70,989]

''All'' compensation means ''all.'' This is not a new requirement under ERISA; it has always existed and finds its roots in trust investment law or the common law of trusts developed by the states. The Prudent Investor Act[8] provides that costs, including compensation, must be appropriate and reasonable and encourages trustees to avoid and minimize fees or compensation of any type that are not justified by the needs and objectives of the trust. However, trustees and/or fiduciaries cannot assess the reasonableness of fees unless they have sufficient information to make that assessment. The same applies to conflicts of interest that are not always apparent without requesting and obtaining additional information to assess the potential damage they may cause.

Because plan sponsors have historically failed to fully understand their role, they have failed to demand from service providers the necessary information to make decisions in the participants' best interests. Service providers who are retained or function as fiduciaries are equally guilty of failing to understand their role and their obligation to divulge information even when it is not requested. ERISA obligates a fiduciary to be truthful and to fully communicate the facts. To lie, mislead, remain silent, or omit pertinent information that may affect a participant's outcome, regardless of whether the information was requested by the participant, has consistently been held by courts to be a breach of fiduciary duty.[9]

The Third Circuit has emphasized that such duty to inform is a constant thread in the relationship between beneficiary and trustee, and it entails not only a negative *duty not to misinform* but also *an affirmative duty to inform when the trustee knows that silence might be harmful.*[10]

Similarly, the Ninth Circuit recognized that an administrator's disclosure duty ''may in some circumstances *extend to additional disclosures [beyond the requirements of ERISA Sections 101-111] where the interests of the beneficiaries so require.''* [11]

The Sixth Circuit has held that to prove that the defendant has breached its fiduciary duty, the participant must show that the defendant was acting in a fiduciary capacity when it made the representations, the information misrepresented was material, and the participant relied on the misrepresentation to his detriment.[12] It has also ruled that ''misleading communications to plan participants regarding plan administration . . . will support a claim for breach of fiduciary duty.''[13]

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[7] Marshall v. Kelly, 465 F. Supp. 341 (W.D. Okla. 1978); ''ERISA Fiduciary Answer Book,'' Fourth Edition, Question 5:15, ''What types of transactions are included in the prohibition against furnishing goods, services, and facilities between plans and parties in interest?'' - Example 2 (Page 5-13).

[8] Adopted 1990 by the American Law Institute's Third Restatement of the Law of Trusts (''Restatement of Trusts 3d'').

[9] Glaziers & Glassworkers Union Local 252 Annuity Fund v. Newbridge Sec., Inc., 823 F. Supp. 1191 (E.D. Pa. 1993), aff'd in part and rev'd in part, 93 F.3d 1171 (3d Cir. 1996) (a specific request for information is not necessarily a prerequisite for finding a fiduciary breach to inform); Jordan v. Federal Express Corp., 116 F.3d 1005, 1016 (3d Cir. 1997) (''It is clear that circumstances known to the fiduciary can give rise to this affirmative obligation [to inform] even absent a request by the beneficiary.'').

[10] Bixler v. Central Pennsylvania Teamsters Health & Welfare Fund, 12 F.3d 1292 (3d Cir. 1993).

[11] Hughes Salaried Retirees Action Committee v. Administrator of Hughes Non-Bargaining Retirement Plan, 72 F.3d 686, 694 (9th Cir. 1995); *see also* Calobrace v. American Nat'l Can Co., 1995 U.S. Dist. LEXIS 915 (N.D. Ill. Jan. 26, 1995) (when fiduciaries have a duty to disclose, their silence may be deemed to constitute fraud).

[12] James v. Pirelli Armstrong Tire Corp., 305 F.3d 439 (6th Cir. 2002).

[13] Berlin v. Michigan Bell Tel. Co., 858 F.2d 1154, 1163 (6th Cir. 1988).

The Second Circuit has held that an ERISA fiduciary has the duty to deal fairly and honestly with the plan beneficiaries and may not affirmatively misrepresent the terms of the plan.[14] It also ruled that a party will be deemed to have breached its fiduciary duties by deliberately misleading participants as to the effect a change in their position would have on their benefits.[15]

The Seventh Circuit decided that ''misrepresentations and omissions [are] breaches of . . . fiduciary obligations. Lying is inconsistent with the duty of loyalty owed by all fiduciaries.''[16]

''Nevertheless, the proposal's application to contracts or arrangements between plans and the listed categories of services providers should not be construed to imply that responsible plan fiduciaries do not need to obtain and consider appropriate disclosures before contracting with service providers who do not fall within these categories. Responsible plan fiduciaries must continue to satisfy their general fiduciary obligations under ERISA with respect to the selection and monitoring of all service providers.'' [72 Fed. Reg. 70,989]

DOL emphasizes the historic importance of obtaining full disclosure of all fees from all service providers, in particular, those paid from plan assets. In fact, the DOL makes clear that obtaining full disclosure is a basic fiduciary obligation when selecting and monitoring all service providers. . .a requirement that has always existed.

''Further, the responsible plan fiduciary, consistent with its general fiduciary obligations under ERISA, must ensure in its negotiations with a service provider that he or she obtains current and accurate information from the service provider sufficiently in advance of entering into the contract or arrangement to allow the fiduciary to prudently consider the information.'' [72 Fed. Reg. 70,990]

DOL references the general fiduciary obligation to obtain current and accurate information. A plan sponsor who retained a service provider without obtaining such information has failed to act in the best interest of the plan participants and is vulnerable to a claim for a fiduciary breach.

The Department's attention to service providers' potential conflicts of interest is not new. For example, in 2005 the Department issued guidance with the Securities and Exchange Commission concerning potential conflicts of interest involved in pension consultant relationships. [*See* 72 Fed. Reg. 70,991]

When has ERISA ever permitted a fiduciary to personally engage in or permit any service provider to engage in a conflict of interest? The very essence of a conflict is the willingness to prioritize the interests of someone or some entity above that of the plan participants. This is and has been a violation of ERISA § 404(a)(1)(A) exclusive benefit rule. In fact, the need to avoid this breach has always required a fiduciary to research any potential conflicts with any prospective service providers as part of the initial and ongoing due diligence process.

The proposed regulation requires a service provider to explicitly acknowledge its status as a fiduciary in the contract. The DOL comments that it

''believes it is important for the responsible plan fiduciary and the service provider to understand at the outset of their relationship whether or not the service provider considers itself a fiduciary and how this status affects the nature of the services to be provided.'' However, a footnote reveals that since 1975, a fiduciary's status has depended more on functions performed than a contractual acknowledgement.[17]

Currently, the only written acknowledgement requirement under ERISA exists for investment managers as defined under ERISA § 3(38). However, the proposed regulations will demand that all service providers acting as fiduciaries acknowledge in writing their fiduciary status. It is presumed that failure to disclose and acknowledge one's fiduciary status, once determined by a federal court, will be deemed a prohibited transaction under § 408(b)(2), and thus subject the party who failed to acknowledge fiduciary status to the liability prescribed under ERISA §§ 409(a), 411, 501, and 502. What may not change is the continuation of some service providers to function as fiduciaries but deny their fiduciary status. This is probably inevitable as a result of the intense competition to capture a larger share of $2.5 trillion in retirement assets. A fiduciary should be cognizant of this possibility and take precautions to avoid retaining a service provider who is unwilling to accept fiduciary liability for fiduciary functions.

Section 404(a) of ERISA requires that the responsible plan fiduciary engage in an objective process designed to elicit information necessary to assess not only the reasonableness of the compensation or fees to be paid for services, but also the qualification of the service provider and the quality of the service that will be provided. [72 Fed. Reg. 70,993]

The footnote to this statement references two Information Letters issued by the DOL, i.e., D. Ceresi (Feb 19, 1998) and T. Konshak (Dec. 1, 1997). These Information Letters are evidence that the DOL expected a fiduciary to elicit information necessary to assess a service provider's qualifications, quality, and costs for services rendered as well as evaluate any potential for self-dealing, conflicts of interest, or other improper influence by a service provider.

''[w]hen selecting or monitoring service providers, plan fiduciaries must act prudently and solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. To meet these obligations, it is vital that fiduciaries have enough information to make informed assessments and decisions about the services, the costs and the providers. In this regard, the Department has published interpretive guidance concerning the disclosure and other obligations of plan fiduciaries and service providers under sections 404, 406(b) and 408(b) of ERISA.''[72 Fed. Reg. 70,995]

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[14] Abbruscato v. Empire Blue Cross & Blue Shield, 274 F.3d 90 (2d Cir. 2001); *see also* Sprague v. General Motors Corp., 92 F.3d 1428 (6th Cir. 1996).

[15] Devlin v. Empire Blue Cross & Blue Shield, 274 F.3d 76 (2d Cir. 2001) (plan administrator may not affirmatively misrepresent the terms of a plan).

[16] Peoria Union Stock Yards Co. Ret. Plan v. Penn Mut. Life Ins. Co., 698 F.2d 320, 326 (7th Cir. 1983).

[17] ''Thus, fiduciary status depends on a factual analysis of a person's activities with respect to a plan. Formal agreements stating whether a person is a fiduciary are not dispositive of whether the person actually is a fiduciary under ERISA by virtue of the functions performed.'' 29 C.F.R. § 2509.75-8

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The obligations referenced by the DOL are not new: the obligation to disclose and obtain information to evaluate the reasonableness of fees or the prudence of selecting a service provider has always existed. Evidence supporting this premise is referenced in a footnote in the proposed regulation: Advisory Opinions 97-15A and 97-16A (''Aetna letter''), both issued May 22, 1997, reflect a non-fiduciary service provider taking the initiative to disclose various sources of hidden undisclosed revenue received when plan assets are invested in mutual funds. The DOL emphasizes in both letters that ''the responsible plan fiduciaries *must obtain sufficient information* regarding any fees or other compensation. . .*to make an informed decision* whether. . .compensation for services is no more than reasonable.'' Advisory Opinion 97-16A emphasizes that ''services charges are fully disclosed.'' It also states that Aetna will disclose the receipt of fees from unrelated funds (i.e., including 12b-1 fees) in the marketing and other disclosure materials provided to the plan fiduciaries. In fact, Aetna commits to providing plan sponsors with a statement that will *enumerate the services* that ALIAC provides to the mutual funds and the rate of fees received. In exchange for open honest fee transparency, the DOL provides both parties with an opinion that the acts of the non-fiduciary service providers will not cause the service providers to be considered as fiduciaries. Advisory Opinion 97-16A closes with a DOL directive drawn directly from the general fiduciary obligations inherent to ERISA § 404 since inception: ''the responsible plan fiduciaries *must assure that the compensation paid directly or indirectly* by the plan to ALIAC is reasonable, taking into account the services provided to the plan as well as any other fees or compensation received by ALIAC in connection with the investment of Plan assets.'' Clearly, the DOL expects plan fiduciaries to do everything in their power to obtain the necessary information to make informed decisions in the best interests of participants.

Plan fiduciaries already have a fiduciary duty to evaluate the reasonableness of offers from service providers, and they already have access to tools like the Model Plan Fee Disclosure Form to assist them in asking service providers questions in order to encourage disclosure. [72 Fed. Reg. 71,000]

This is one more example of the DOL noting the existence of statutory and regulatory obligations to fully disclose and comprehensively evaluate fees in light of services rendered. In addition, the DOL emphasizes its expectation that fiduciaries will question the service provider to ensure that the necessary information is obtained for proper evaluation before a decision is made in the best interests of plan participants.

Failure to comply with the new explicit requirements of proposed § 408(b)(2) causes the plan to be deemed as engaging in a prohibited transaction under ERISA § 406(a)(1)(C). Under ERISA, there are both legal and equitable remedies available when a prohibited transaction occurs. In addition, § 408(b)(2) does not provide a statutory exemption for other requirements of ERISA § 406(a), § 406(b), or the general fiduciary requirements of § 404.[18] Further, the DOL makes clear that fiduciaries have always been required to elicit sufficient information from service providers to make informed decisions that are in the best interests of plan participants. This has not changed.

In addition, service providers who accept or who function in a fiduciary role are equally obligated to disclose all the necessary information to the plan sponsor that the plan sponsor has always been required to request. A fiduciary that has failed to identify any conflicts of interest and to elicit a specific description of all direct and indirect compensation (including any term used to describe revenue sharing) by services rendered has failed to adhere to the duty of loyalty imposed by ERISA § 404(a)(1)(A). Failure of a fiduciary to adhere to this duty justifies a participant's claim of fiduciary breach and, as was the original intent of ERISA, permits the participant to seek both legal and equitable remedies in a federal court. In light of current litigation activity, it should come as no surprise that participants have decided to seek enforcement of those rights established by ERISA. 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. It is the litigation activity of the past several years and the outcry of plan participants that have drawn the attention of Congress and the DOL, and in turn prompted the issuance of the regulatory modifications under § 408(b)(2) that explicitly mandate behavior that was always expected of a prudent fiduciary.

Conclusion. Should they be finalized, only time will tell whether the explicit requirements and consequences of the proposed regulations under § 408(b)(2) are sufficient to conform future behavior to the fiduciary standards imposed by ERISA. As far as the past is concerned, fiduciaries and service providers are vulnerable to a continued barrage of legal accountability as participants become familiar with and seek to enforce their legal rights.

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[18] An ERISA § 408 exemption does no more than avoid the prohibitions of § 406 of the Act; it does not exempt the transaction from the fiduciary duties mandated in ERISA § 404(a)(1). This Court and other circuits have repeatedly approved this construction of ERISA, which Congress explicitly set forth in ERISA's legislative history. *Kuper v. Iovenko*, 66 F.3d 1447, 1458 (6th Cir. 1995); Martin v. Feilen, 965 F.2d 660, 665 (8th Cir. 1992), *cert. denied*, 506 U.S. 1054 (1993); McMahon v. McDowell, 794 F.2d 100, 110 (3rd Cir.), *cert. denied*, 479 U.S. 971 (1986); Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1992), *cert. denied*, 467 U.S. 1251 (1984); Eaves v. Penn, 587 F.2d 453, 459 (10th Cir. 1978); S. Rep. No. 93-127 at 31, *reprinted in* 1974 U.S.C.C.A.N. 4838, 4867.