

# Employee Benefit ■ Plan Review

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## New Proposed 408(b)(2) Fee-Disclosure Requirements Have the Potential to Kill 401(k) Plans as We Know Them: What Plan Sponsors Should Do Now

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**M**ore than a year ago, in December 2007, the Department of Labor issued proposed regulations under ERISA Section 408(b)(2). The regulations would mandate disclosure of service-provider compensation and potential conflicts of interest in advance of entering into an arrangement to provide services to an ERISA-covered plan. Under the proposed rules, if service providers do not fully comply with these regulations, a provider's agreement would be considered a prohibited transaction, resulting in reimbursement of the service provider's compensation and potential excise taxes.

If managing retirement plans were not already difficult enough, plan sponsors now need to be fully aware of current provider contracts, reasonableness of fees at a plan level, and be required to inform and educate participants surrounding plan fees. Why?

Under ERISA, all fiduciary actions must be in the best interest of plan participants. Second, all fiduciary actions must be documented. Finally, all fiduciary actions must be periodically reviewed for reasonableness. With all that being said, the difficulty and depth of what is proposed will force administrative expenses to *rise* at the service provider level. Moreover, the proposed regulation will require enhanced education and communication campaigns to plan participants. If education and communication programs are not rolled out to explain these fee disclosures, the questions and concerns surrounding retirement plans will dramatically increase in the form of negative sentiments.

It has the potential to kill 401(k) plans as we know them today.

### BACKGROUND

In October 2007, plan assets in 401(k) plans had never been greater. Plan participants had all but erased the pain they felt from fallen plan balances only seven years earlier. Today, plan participants are angry. Plan participants are stopping contributions. Plan participants are selling out of diversified portfolios and buying into money market accounts. Fear is at an all-time high.

Compound these feelings with the concept that participants will be forced in the coming months to find out they have been "paying," on average, one percent to two percent of their account value to "someone" in the form of fees. One can imagine hearing their outrage already: "For what am I paying this outfit thousands of dollars, only to lose 30 percent? I have the same account value that I had five years ago!" "My account value has less in it than I put into it! I make 20 percent in my account that I manage myself!" Whether these accusations are justified or not, the fact of the matter is they are the participant's perception.

Originally, it was believed these would be finalized by November 1, 2008. However, because of the financial crisis, the final regulations have yet to be released by the Office of Management and Budget. Here are the key items of the proposed 408(b)(2) regulations.

First, disclosure requirements would apply to arrangements for plan services from service providers that:

- Provide services as a fiduciary under ERISA or under the Investment Advisors Act of 1940, or
- Provide banking, consulting, custodial, insurance, investment advisory (to the plan or participants), investment

management, recordkeeping, securities or other investment brokerage, or third party administration services, or

- Receive any indirect compensation in connection with accounting, actuarial, appraisal, auditing, legal, or valuation services.

Next, the contract with the service provider must be in writing.

In addition, the service provider must disclose all direct and indirect compensation it will receive in connection with the services.

If a service provider cannot disclose compensation in terms of a specific dollar amount, then the service provider can disclose compensation by using a formula, a percentage of the plan's assets, or a per-capita charge for each participant or beneficiary.

For bundled arrangements, the bundled service provider must disclose information concerning all services to be provided in the bundle, regardless of who provides them, and the aggregate direct compensation, as well as all indirect compensation from third parties that will be received by the service provider, its affiliates or subcontractors within the bundle.

Generally, the bundled provider is not required to break down this aggregate compensation or fees among the individual services comprising the bundle. However, the bundled provider must separately disclose (1) compensation of any party providing services under the bundle that receives a separate fee charged directly against the plan's investment reflected in the net value of the investment, such as management fees paid by mutual funds to their investment advisers, float revenue, and other asset-based fees (if paid in addition to the investment management fee), and (2) compensation on a transaction basis, such as

finder's fees, brokerage commissions, or soft dollars (even if paid from mutual fund management fees or similar fees).

The service provider must identify whether it will provide services to the plan as a fiduciary.

Service providers must notify fiduciaries of any material changes within 30 days of the service provider's knowledge of the change.

The consequences of failing to satisfy the proposed regulations would be that the contract or arrangement would not be "reasonable" and would, therefore, be a prohibited transaction.

Finally, the DOL also published a proposed prohibited transaction class exemption which would not hold the fiduciary liable, providing certain conditions are met, if the service provider, unbeknownst to the fiduciary, fails to satisfy its disclosure obligations. Among the conditions required would be a written request for the missing disclosures to the service provider and a notice to the DOL if the disclosures are not provided within 90 days of the written request.

#### **WHAT PLAN SPONSORS SHOULD DO NOW**

No one can predict what the final regulations will include. Plan sponsors should plan for the worst and hope for the best.

In particular, it is clear that plan sponsors will need to increase participant education, annually benchmark fees, and be fully aware of all contracts and business partners tied into the 401(k) plan. For plan sponsors, here is a starting point that will help prepare for these sweeping changes.

#### **Participant Education**

The average 401(k) participant believes his or her 401(k) plan operates free of charge. It is from this starting point that plan sponsors will

need to educate participants on how the 401(k) and mutual fund industries function. Fees such as investment management, sub-Transfer Agency, 12b-1, and others will need to be identified, explained, and illustrated. In down markets, plan sponsors will need to justify and prove the value of fees associated with their retirement plan.

#### **Fee Benchmarking**

Plan sponsors will need to monitor and benchmark fees. The legislation defines this criterion as "reasonableness" in fees. To define "reasonableness," one will need to define the process for monitoring fees. Few plan sponsors, however, have the expertise to do this. They will need to rely on specialists whose core business is understanding the retirement marketplace and who have the resources to benchmark fees across industries. Having a strong relationship with a trusted consultant will be even more important as litigation in this area represents the easiest and greatest opportunity for participant lawsuits.

#### **Review Service Contracts**

Finally, plan sponsors will need to read the fine print. They will need to know how their service providers are being paid, what they are being paid, and by whom they are being paid. Each service provider will need to provide an updated contract that illustrates the fees being charged for the services being provided. A partnership built on full disclosure and trust will be the only partnership that plan sponsors can adopt. ☺

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