

ERISA Fee Disclosures: Best Practices for Fiduciaries

BY MARCIA S. WAGNER

In response to intense public scrutiny and a series of lawsuits brought against plan sponsors and fiduciaries concerning the compensation paid to 401(k) service providers, the Department of Labor (DOL) created a three-part fee disclosure initiative aimed at greater transparency for the benefit of such plans and their participants. In addition to changes to Form 5500, Schedule C reporting, the DOL issued two final regulations: (1) a regulation on participant-level fee disclosure [DOL Reg. § 2550.404a-5], and (2) a regulation on plan sponsor-level fee disclosure [DOL Reg. § 2550.408b-2(c)]. It is now up to plan sponsors and participants to use the disclosure information obtained as a result of these initiatives in

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a manner that yields prudent and effective investment decisions.

History and Background for DOL's Fee Disclosure Regulations

The mission statement of the Employee Benefits Security Administration of the Department of Labor (DOL) is telling and foreshadows much of the increased regulatory activity that has and will continue to occur with regard to retirement plans:

The mission . . . is to assure the security of the retirement, health and other workplace related benefits of America's workers and their families. We will accomplish this mission by *developing effective regulations*; assisting and educating workers, plan sponsors, fiduciaries and service providers; and *vigorously enforcing the law*. [http://www.dol.gov/ebsa/aboutebsa/org_chart.html#mission (emphasis added)]

True to its mission, the DOL has been engaged in the development of several regulatory projects, as discussed below, to address the vexing issue of fee disclosure. The retirement plan world has experienced a monumental shift over the last 30 or so years from a defined benefit model to a defined contribution model, with special emphasis on participant-directed accounts. At the same time, the sophistication and complexity of investment products and services, delivered à la carte or in bundled arrangements, have increased exponentially. One result of this evolution has been the inherent difficulty faced by plan sponsors and participants when assessing the nature of services and their relationship to fees received by the service provider and its affiliates (if any) from the plan and other payers. This has made it extremely difficult for plan fiduciaries and participants to prudently evaluate the alternatives offered by plan providers and to fully understand the true costs of the retirement plan.

With the annual cycles of fee disclosure mandated by the new regulations well underway, the focus has shifted from service providers (the disclosing party) to plan fiduciaries and participants (the recipients), who are now expected to make critical decisions using the new information in accordance with the prudent process prescribed by the DOL and other government agencies. Thus, it is incumbent on plan fiduciary and participant alike to use the newly available information to make more informed choices, and especially for plan fiduciaries to have processes and procedures in place to review plan services and fees in light of the disclosures made by the service provider.

It is important to note at the outset that the DOL enforcement efforts are centered on the service providers and the plan administrators. In this context, the phrase “plan administrator” is defined in Section 3(16) of ERISA to mean the person or entity that is responsible for the administration of the plan. In many plans, the plan administrator is the plan sponsor; in others, an individual or committee may be appointed to this task by the plan sponsor. Throughout this article, we will use the phrases “plan administrator” and “plan sponsor” interchangeably, reflecting the fact that the duty to ensure that someone is “on first” in regard to the plan’s operation rests primarily on the employer.

To appreciate the obligations resulting from fee disclosure, it is important to retrace the steps already taken.

Informal DOL Efforts in 90s

Over a decade before the DOL took any formal rule-making actions, it tried to improve fee transparency in the 401(k) industry through informal action and non-binding informational guidance.

- In 1997, the DOL held a hearing on 401(k) plan fees, which appeared to have been in response to several consumer magazines criticizing the size of such fees. [“Protect Yourself against the Great Retirement Rip-off,” *Money Magazine* (April 1997); “Your 401(k)’s Dirty Little Secret,” *Bloomberg Personal* (September 1997)]
- In 1998, the DOL published a 19-page booklet, “A Look At 401(k) Plan Fees,” for plan participants [http://www.dol.gov/ebsa/publications/401k_employee.html] and a 72-page report, “Study of 401(k) Fees and Expenses,” for plan sponsors. [<http://www.dol.gov/ebsa/pdf/401krept.pdf>]

Unfortunately, the DOL’s efforts to persuade plan sponsors and plan participants to ask the right questions about 401(k) fees were insufficient for purposes of changing the day-to-day behavior of plan fiduciaries and plan providers. Fees remained either hidden or misunderstood by even the most diligent plan sponsors, as did the full scope of affiliated relationships and potential conflicts-of-interest among service providers. (Compensation to affiliated parties may be permissible under statutory or other DOL exemptions, although the potential for conflicted advice still remains a factor. For example, PTE 75-1 and PTE 86-128 provide relief from the prohibited transaction rules for affiliated brokerage services; and PTE 77-4 provides relief from

the prohibited transaction rules for various plan investment transactions involving mutual funds. The DOL subsequently issued guidance in the form of advisory opinions, such as Advisory Opinion 2001-09A, for outsourcing investment advice to an independent financial expert, or Advisory Opinion 2005-10A, for reduction of fees by enterprise-wide fee leveling. Statutory relief with regard to certain transactions, such as investment advice to participants in participant-directed plans, was enacted in the Pension Protection Act of 2006 by amending the Employee Retirement Income Security Act of 1974 (ERISA.)

GAO Reports

The US Government Accountability Office (GAO), which is also known as the “investigative arm of Congress,” also issued a series of influential reports expressing concern relating to the problem of “hidden” fees and conflicts within the 401(k) industry.

- The November 2006 report by the GAO, *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, [<http://www.gao.gov/assets/260/253638.pdf>] reported that the “problem with hidden fees is not how much is being paid to the service provider, but with knowing what entity is receiving the compensation and whether or not the compensation fairly represents the value of the service being rendered.”
- The GAO concluded in its July 2008 report, *Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors* [<http://www.gao.gov/assets/280/278247.pdf>] that plan sponsors were unable to satisfy their fiduciary obligations without disclosure of the “hidden” compensation flowing from the plan’s investments to its service providers (e.g., recordkeeper and pension consultant).
- In its March 2009 report, *Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans* [<http://www.gao.gov/new.items/d09503t.pdf>], the GAO concluded that there is a “statistical association between inadequate disclosure of potential conflicts of interest and lower investment returns for ongoing plans, suggesting the possible adverse financial effect of nondisclosure” of indirect compensation arrangements.

401(k) Fee Litigation

Starting with the putative class action lawsuit claims filed against over a dozen plan sponsors

and related plan fiduciaries in 2006 by the law firm Schlichter, Bogard & Denton, LLP of St. Louis, Missouri, there have been several waves of similar lawsuits against plan fiduciaries and their service providers. The core allegation in these suits is that the plan's fiduciaries breached their fiduciary duties under Section 404(a) of ERISA by causing or allowing plan providers to be paid excessive fees. In many instances, the alleged excessive payments included "hidden" or undisclosed revenue sharing payments made by third parties, such as mutual fund providers.

The case law in this area continues to evolve as the courts proceed with their rulings in the 401(k) fee litigation arena. Here is a summary of a few important court decisions in relation to the 401(k) fee litigation during the past year (2012–2013):

- *Tussey v. ABB Inc.* [*Tussey v. ABB, Inc., et al.*, No. 2:06-CV-04305-NKL, 2012 WL 1113291 (W.D. Mo. 2012)] In one of the few cases to go to trial rather than settle or be dismissed on procedural grounds, the court awarded damages of nearly \$37 million plus legal fees and costs (totaling more than \$50 million) against the plan sponsor, ABB, and its recordkeeper, Fidelity Investments. The court held that ABB had used plan assets to subsidize its own corporate costs, noting ABB's lack of benchmarking to assess the reasonableness of the provider's revenue sharing arrangement, as well as Fidelity's retention of certain float income from the plan's available funds. [The decision is now on appeal by both parties in the Eighth Circuit.]
- *Krueger v. Ameriprise.* [*Krueger v. Ameriprise Financial, Inc., et al.*, No. 11-cv-02781, SRN/JSM, (W.D. Minn. 2012)] Ameriprise employees filed a suit against their own in-house plan, which included proprietary funds in the plan's investment menu. In denying Ameriprise's motion to dismiss, the court noted that the fact that hundreds of investment options were available to participants through the plan's brokerage window would not insulate the plan's fiduciaries from liability (thereby limiting the reach of the Seventh Circuit's decision in *Hecker v. Deere & Co.* [556 F.3d 575, 578 (7th Cir. 2009)]) The *Hecker* court had cited a brokerage window as evidence that plan fiduciaries had offered a sufficiently wide array of investment options to fulfill their fiduciary duties generally, and under ERISA Section 404(c).
- *Healthcare Strategies Inc. v. ING Life Ins. & Annuity Co.* [*Healthcare Strategies Inc. v. ING Life Ins. & Annuity Co.*, No 3:2011cv00282, ((D. Conn. Sept. 26, 2012))] In this class action lawsuit, Healthcare Strategies as plan sponsor filed ERISA claims against an insurance platform (ING) on behalf of itself and all "similarly situated" plan clients. The court ruled in favor of class certification, specifically holding that ING's contractual right to delete and substitute investment funds in the plan's menu made it a plan fiduciary for class certification purposes. The lawsuit alleges that ING, while acting in a fiduciary capacity, received and mischaracterized revenue sharing "kickbacks" from certain mutual fund families in violation of ERISA Section 406(b)(3).

DOL Regulatory Project Commences in 2006

To address the fee-related concerns raised in GAO report as well as by Congress, successive Presidential administrations, the plaintiffs' bar, and the public, the DOL developed a three-pronged regulatory project several years ago designed to increase fee transparency.

- *Form 5500, Schedule C.* In July 2006, the DOL proposed changes to the annual information that must be filed on behalf of plans on the Form 5500. Specifically, Schedule C to the Form 5500 was revised to require additional detailed information concerning the direct and indirect compensation received by the plan's service providers. This involved a look-back approach, in that the reporting period was for plan years already complete. The revised reporting rules for Schedule C became effective with the 2009 plan year. [72 Fed. Reg. 64731 (Nov. 16, 2007)]
- *408(b)(2) Fee Disclosures for Plan Sponsors.* With regard to the second prong of the DOL's regulatory project, in 2007, the DOL proposed a new set of fee disclosure rules that would require covered service providers to deliver upfront fee disclosures to plan sponsors reasonably in advance of entering into service contracts or arrangements. [72 Fed. Reg. 70988 (Dec. 13, 2007)] After several iterations, and a great deal of industry comment and debate, the final version went into effect on July 1, 2012. [77 Fed. Reg. 5632 (Feb. 3, 2012). This final version replaced the interim final version published at 75 Fed. Reg. 41600 (July 16, 2010).] ERISA Section 408(b)(2) provides a general exemption from the prohibitions under ERISA Section 406 of a service contract or arrangement between a plan and a party-in-

interest, where the contract is reasonable, the services are necessary for the establishment or operation of the plan, and no more than reasonable compensation is paid for the services. The final regulation [DOL Reg. § 2550.408b-2(c)] brought much needed clarity to the question of what constitutes a “reasonable” contract by conditioning applicability of the exemption on the disclosure of prescribed categories of information to the responsible plan fiduciary.

- *404a-5 Fee Disclosures for Participants.* The third and final prong of the DOL’s regulatory project involves mandatory disclosures from the plan sponsor to the plan’s participants. The DOL first proposed these “404a-5 fee disclosures” in 2008 [73 Fed. Reg. 43014 (July 23, 2008)], imposing a new disclosure duty on defined contribution plan sponsors. The final participant-level disclosure rules [75 Fed. Reg. 64910 (Oct. 20, 2010)] became effective on August 30, 2012, in the case of calendar year plans.

The “408(b)(2) Disclosure Regulation” and the “404a-5 Disclosure Regulation,” the two key components of the DOL effort to provide upfront and increased transparency in the marketplace, went into effect in 2012. Although these rules are relatively new, both service providers and disclosure recipients now have the opportunity to make plan-related decisions with more complete information about fees. A review of the more salient features of the 408(b)(2) Disclosure Regulation and the 404a-5 Disclosure Regulation, and a summary of the evolving “best practices” being considered by plan fiduciaries in response to the benefits and burdens of the new regulatory regime, are set forth below.

408(b)(2) Disclosure Regulation—Fee Disclosures for Plan Sponsors

On February 3, 2012, the DOL published the final 408(b)(2) Disclosure Regulation requiring certain disclosures by covered service providers to the responsible plan fiduciaries of covered plans. The disclosures relate to services to be performed by service providers and the compensation they will receive, and, as noted above, are required as a condition for the service contract or arrangement to avoid characterization as a prohibited transaction.

Purpose and Scope

The 408(b)(2) Disclosure Regulation is designed to plug a gaping “hole” in the regulatory oversight of ERISA plans. As succinctly explained by the DOL in its release of the interim final regulations, “plan

fiduciaries have a duty to consider a service provider’s compensation from all sources, but service providers are not obligated to disclose compensation from other sources.” [See Preamble at 75 Fed. Reg. 41618.] However, the final DOL 408(b)(2) Disclosure Regulation created the desired symmetry between the fee information that sponsors must review to satisfy their fiduciary duties, and the fee information that providers must proactively disclose to plan sponsors to avoid a prohibited transaction. The DOL has stated, “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 plans participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan.” [See Preamble at 77 Fed. Reg. 5632.]

Prior to the 408(b)(2) Disclosure Regulation, providers were not specifically obligated to furnish fee information under ERISA, resulting in many plan sponsors being unaware of the “indirect” compensation that providers received through the plan’s investments. Such indirect compensation may include ongoing payments from the funds in the plan’s menu or revenue sharing payments from the fund manager or sponsor. Of course, if the plan sponsor was unaware of the amount, or even the existence, of the flow of such payments from its funds to a provider, it would have no way of determining whether these “hidden” fees were reasonable. These costs are typically embedded in the expenses of the plan’s investment funds, which can hurt participants by cutting into their investment earnings.

The disclosure requirement under the 408(b)(2) Disclosure Regulation applies to all “covered service providers,” which include any of the following providers that reasonably expect to earn \$1,000 or more in connection with its plan-related services:

- fiduciary service provider or investment adviser registered under either the Investment Advisers Act of 1940 or any state law,
- recordkeeping platform, or
- other provider of plan-related services who receive any indirect compensation. [DOL Reg. § 2550.408b-2(c)(1)(iii)(A)–(C)]

Prohibited Transaction Rules

The use of plan assets to pay a service provider’s fees is a prohibited transaction under Section 406(a)(1)(C) of ERISA. However, ERISA Section 408(b)(2) provides

relief from ERISA's prohibited transaction rules for the use of plan assets to pay for services between a plan and a party in interest (*e.g.*, a recordkeeper). The conditions of this statutory exemption are satisfied if:

- the contract or arrangement is a reasonable arrangement,
- the services are necessary for the establishment or operation of the plan, and
- no more than reasonable compensation is paid for the services.

These statutory conditions provide an important safeguard for participants under ERISA, requiring plan sponsors to protect them from excessive fees.

The 408(b)(2) Disclosure Regulation provides that a service arrangement will qualify as a "reasonable arrangement" only if the service provider delivers its fee disclosures to a "responsible plan fiduciary" [DOL Reg. § 2550.408b-2(c)(1)(iv)] (typically the plan sponsor) reasonably in advance of the date of entering into the arrangement or contract for services. [DOL Reg. § 2550.408b-2(c)(1)(v)] A failure to make this disclosure means the arrangement is unreasonable, and voids the prohibited transaction exemption, subjecting the service provider and possibly the plan fiduciary to excise taxes and other liability.

Required Elements for Initial Fee Disclosures

The upfront fee disclosure provided by the covered service provider must include the following elements:

- a description of services,
- if applicable, the status of the provider as a plan fiduciary or registered investment adviser,
- a description of all direct compensation,
- a description of all indirect compensation, including the identity of the payer of the indirect compensation,
- a description of any compensation paid among related parties (which include any affiliate or subcontractor of the service provider),
- a description of any compensation payable upon termination of the arrangement, and
- the manner of receipt of the provider's compensation. [DOL Reg. § 2550.408b-2(c)(1)(iv)]

If a provider is serving without explicit compensation, a reasonable and good faith estimate of the *cost* of the services to the plan must be provided along with an explanation of the methodology and assumptions underlying the estimate. [DOL Reg. § 2550.408b-2(c)(1)(viii)(B)(3)]

In its preamble to the final regulation, the DOL also notes that the "disclosure of expected compensation in the form of known ranges can be a 'reasonable' method for purposes of the final rule." [See Preamble at 77 Fed. Reg. 5645.] However, the DOL indicated that, whenever possible, more specific, rather than less specific, compensation information is preferred. Covered service providers generally must provide to a responsible plan fiduciary the information necessary to assess the reasonableness of total compensation, both direct and indirect.

Annual Investment Disclosures by Recordkeeping Platforms

Under the 408(b)(2) Disclosure Regulation, in addition to providing their initial fee disclosures, recordkeeping platforms must also provide certain annual disclosures with respect to the designated investment alternatives (DIAs) accessible to the plan through their platforms. This disclosure requirement for the plan's DIAs may be satisfied by passing through current disclosure materials of the investment's issuer, such as a prospectus, to the plan sponsor on an annual basis. [DOL Reg. § 2550.408b-2(c)(1)(iv)(F)(2)] This section of the regulation essentially extends the required disclosure for a reasonable contract to include the information the service provider has that the plan fiduciary needs to comply with the participant-level disclosure under the 404a-5 Disclosure Regulation.

Timing for Disclosure Updates

Changes to information furnished by service providers are required to be disclosed generally within 60 days of the date on which the service provider was informed of the change, unless extraordinary circumstances beyond the service provider's control made this impossible, in which case, the new information must be disclosed "as soon as practicable." There is an exception for disclosures both by fiduciaries managing "look through" investment products and by recordkeeping platforms. Disclosure of any changes to the investment information required for these providers must now be made at least *annually*, thereby relaxing the 60-day rule. This eliminates the need to make frequent, or even non-stop, notifications with regard to minor modifications of investment information relating to DIAs and other investment products. [DOL Reg. § 2550.408b-2(c)(1)(v)]

Information That Must Be Provided Upon Request

Service providers generally must respond to the request of a plan fiduciary for any additional

information needed to satisfy ERISA's reporting and disclosure requirements, such as the annual Form 5500 filing requirement. The final 408(b)(2) Disclosure Regulation offers flexibility with respect to the deadline for responding to this request by providing that the required information merely needs to be delivered "reasonably in advance" of the reporting or disclosure deadline cited by the plan fiduciary. The final rule further provides that, where the disclosure cannot be made due to circumstances beyond the service provider's control, it must be made "as soon as practicable." [DOL Reg. § 2550.408b-2(c)(1)(vi)]

Timing for Corrections

The interim final 408(b)(2) Disclosure Regulation has provided that good faith errors or omissions in disclosing information could be corrected as soon as practicable, but not later than 30 days from the date a service provider knows of the error or omission. The final rule expands this treatment to errors or omissions that occur in connection with disclosure updates (*i.e.*, any required disclosures describing changes to previously provided information). [DOL Reg. § 2550.408b-2(c)(1)(vii)]

Conditions for Fiduciary Liability Relief Under Class Exemption

The final 408(b)(2) Disclosure Regulation contains a class exemption, which provides a plan fiduciary (*i.e.*, the plan sponsor or administrator) with relief from liability under ERISA's prohibited transaction rules if the service provider does not comply with the disclosure obligations. It is critical for the fiduciary to comply with this exemption to avoid a fiduciary breach and/or prohibited transaction excise tax when the service provider is noncompliant.

To qualify for this relief, the fiduciary must not have known that the covered service provider failed to make required disclosures and must have reasonably believed that such disclosures were made. Upon discovering that the service provider failed to disclose the required information, the plan fiduciary must request in writing that the service provider furnish such information. [DOL Reg. § 2550.408b-2(c)(1)(ix)(A)–(B)]

If the service provider fails to comply with this request within 90 days, the plan fiduciary must notify the DOL of the provider's noncompliance. If the requested information relates to services to be performed after the 90-day period and such information is not disclosed promptly after the end of the 90-day period, the plan fiduciary *must* terminate the contract or arrangement "as expeditiously as possible"

consistent with its duty of prudence. [DOL Reg. § 2550.408b-2(c)(1)(ix)(C)] In some situations, however, it may be prudent to continue the service arrangement.

Exclusion from Covered Plan Definition

Service providers generally must provide the disclosures required under ERISA Section 408(b)(2) to all of their "covered plan" clients. These clients include an "employee benefit plan" or "pension plan" within the meaning of ERISA Section 3(2)(A) and not described in ERISA Section 4(b). "Covered plans" do not include simplified employee pensions, SIMPLE retirement accounts, individual retirement accounts, individual retirement annuities, and certain legacy 403(b) annuity contracts. [DOL Reg. § 2550.408b-2(c)(1)(ii)]

404a-5 Regulations—Fee Disclosures for Participants

In October 2010, the DOL finalized its regulations concerning the fee and investment-related disclosures that must be provided to participants in 401(k) plans and other defined contribution plans with participant-directed investments. The final 404a-5 Disclosure Regulation generally is consistent with the DOL's 2008 proposed rules, reflecting modest changes based on comments received by the agency.

In its press release announcing the issuance of these final rules, the DOL explained that existing law did not require plans to provide workers with "the information they need to make informed investment decisions regarding the investment of their retirement savings," such as fee and expense information. However, the new rules would enable the estimated 72 million affected participants "to meaningfully compare the investment options under their plans." [<http://www.dol.gov/opa/media/press/ebsa/EBSA20101432.htm>]

For calendar year plans, the initial disclosures of plan and investment information had to be provided by August 30, 2012, and the first quarterly expense statement was required by November 14, 2012 (covering the third quarter).

Types of Plans Covered

The 404a-5 Disclosure Regulation requirements only apply to participant-directed individual account plans, such as 401(k) plans; they do not apply to defined contribution plans with employer or trustee-directed investments. [DOL Reg. § 2550.404a-5(b)(2)]

Many participant-directed plans are designed to comply with the requirements of ERISA Section

404(c), a provision that relieves plan sponsors of any fiduciary responsibility for the investment allocation decisions of individual participants. However, the 404a-5 Disclosure Regulation requirements cover all participant-directed plans, even if they are not designed to comply with ERISA Section 404(c). The regulations modify the DOL's existing regulations under ERISA Section 404(c) to provide that the disclosure requirements of Section 404(c) are fulfilled if the plan administrator complies with the annual and quarterly obligations under the 404a-5 Disclosure Regulations. [See DOL Reg. § 2550.404a-5, DOL Reg. § 404c-1.]

Coverage of Participants

The new disclosure requirement must be provided to all eligible employees, and not merely participants (or beneficiaries) who have actually enrolled in the plan. Thus, the entire eligible employee population must receive the relevant disclosures on an ongoing basis. [DOL Reg. § 2550.404a-5(b)] The required disclosures include both plan-related information and investment-related information.

Annual and Quarterly Disclosure of Plan-Related Information

Under the final 404a-5 Disclosure Regulation, participants must be furnished general information about the plan annually, including an explanation of how participants may give investment allocation instructions and information concerning the plan's investment menu. Plan participants must also receive an annual explanation of the general administrative service fees that may be charged against their accounts as well as any individual expenses charged for individualized services (e.g., plan loan processing fee). [DOL Reg. § 2550.404a-5(c)(1)-(3)] With respect to new participants, this information must be provided before they can first direct investments under the plan.

Participants must also receive certain information on a quarterly basis. They must receive statements that include the quarterly dollar amounts actually charged to their plan accounts as general administrative service fees and as individual expenses, as well as a description of the relevant services. [DOL Reg. § 2550.404a-5(c)(2)(ii)]

The annual and quarterly fee disclosures for general administrative services and individual expenses only apply to the extent such fees are not already reflected in the total annual operating expenses of the plan's investments. [DOL Reg. § 2550.404a-5(c)(2)] For example, if a service provider's fees are paid wholly

through indirect compensation flowing from a plan's investment funds (i.e., the provider's fees are already reflected in each fund's per-share market value or "NAV"), the provider's fees and services would not be subject to these annual and quarterly fee disclosures. However, if any portion of the fees for general administrative services are paid from the total annual operating expenses of any of the plan's investments (e.g., through revenue sharing or 12b-1 fees), an explanation of this fact must be included in the quarterly statements.

Annual Disclosure of Investment-Related Information

Plan participants must receive certain fee and performance-related information relating to the plan's various DIAs in a comparative format, for which the DOL has created a "model comparative chart." [DOL Reg. § 2550.404a-5(d)(2)] This information must be provided on or before the date on which a participant can direct investments, and annually thereafter.

The comparative information that must be provided includes:

- (a) the name and type of investment option,
- (b) investment performance data,
- (c) benchmark performance data,
- (d) fee information, including both the total annual operating expenses of each investment alternative and any shareholder-type fees that are not reflected in the total annual operating expenses, such as commissions and account fees, and
- (e) the Internet Web site address at which additional information is available.

Information That Must Be Provided Upon Request

Upon request, participants must be provided copies of fund prospectuses (or other corresponding documents) as well as any shareholder reports and related financial statements provided to the plan.

Form of Disclosure

The annual disclosures required under the DOL's regulations may be provided separately or as part of the plan's summary plan description (SPD) or participant benefit statements. The required quarterly statements may also be provided separately or as part of the plan's participant benefit statements. All disclosures must be written in a manner calculated to be understood by the *average participant*.

Impact on Plan Sponsor's Other Fiduciary Duties

As expressly provided in the DOL regulations, a plan sponsor's compliance with the disclosure rules will not relieve it of its fiduciary duty to prudently select and monitor the plan's providers and investments.

Evolving "Best Practices" and Other Responses to DOL Fee Disclosure Regulations

The DOL and many voices within the federal government, including the Obama administration, have called for greater fee transparency in the retirement plan marketplace. [See the "Annual Report of the White House Task Force on the Middle Class" (Feb. 2010).] Given the regulatory and litigation-driven scrutiny of plan fees, and the new wave of learning from recent compliance efforts associated with the two fee-disclosure regulations, many plan sponsors have expressed an interest in adopting "best practices" that are intended to satisfy their related fiduciary requirements under ERISA. This is no easy task, as services are often delivered by multiple parties and involve forms of indirect compensation.

Services delivered in a bundled fashion typically are provided by multiple parties, which may include an affiliate or a subcontractor of the main service provider. Outsourcing has many advantages, such as lower costs through economy of scale and sharing the cost of capital necessary to sustain technology platforms. However, it also adds a new party to the service relationship, and the plan sponsor may not be able to identify the outsourced service provider or its qualifications, or distinguish its fee-sharing arrangement.

Indirect compensation among the plan's service providers further complicates the nature of a plan's compensation arrangements. For example, plan assets may be subject to transfer fees, sub-transfer agency fees, and recordkeeping and brokerage fees. It would not be uncommon for an investment complex such as a mutual fund to pay for some or all of those fees, as well as special shareholder services and 12b-1 fees. Not only does the plan administrator's failure to understand the complete scope of these fees hinder the ability to make sound fiduciary decisions, it may result in a prohibited transaction. It is not only imprudent to select a fund with "excessive fees," for example, or for fees to be unreasonable; it also may convert the service provider relationship into a prohibited transaction, with attendant excise taxes and fiduciary liability.

Fee-Related Duties Under ERISA

The 408(b)(2) Disclosure Regulation clearly places the burden of creating the required fee disclosures on the plan's service providers. It also places a heavy burden on plan sponsors that are subject to an ongoing duty to protect the plan and its participants against unreasonable fees. Thus, as part of this general fiduciary duty, plan sponsors will need to review any and all fee disclosures, and they will be held accountable for any misuse of plan assets. Plan sponsors must engage in an objective process designed to elicit the information necessary to assess the qualification of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. [See DOL Field Assistance Bulletin 2002-3 (Nov. 5, 2002), DOL Information Letter to T. Konshak (Dec. 1, 1997).] Fees must be evaluated in the context of value received for dollars spent, and not necessarily for the sole purpose of finding the lowest fee. Any determination must be made by following a fiduciary process that gathers all of the relevant information, and uses experts as necessary to supplement the fiduciary experience of the plan sponsor.

Under the "prudent man" standard of care set forth in Section 404(a)(1) of ERISA, when selecting and monitoring service providers and plan investments, plan fiduciaries must act prudently and solely in the interest of the plan's participants and beneficiaries. Furthermore, plan fiduciaries must discharge their duties for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. In the context of 401(k) plans, these general standards of fiduciary conduct apply to a plan fiduciary's initial selection of investment funds for the plan menu and the initial selection of the plan's service providers, as well as the decision to continue such investment funds and service arrangements on an ongoing basis. The plan-level disclosures made under the 408(b)(2) Disclosure Regulation provide an excellent vehicle for a review of plan fees and investment expenses.

Plan fiduciaries also have an obligation to avoid "prohibited transactions" under Section 406 of ERISA, unless the transaction qualifies for an "exemption" from these restrictions. As discussed above, the use of plan assets to pay service providers is deemed to be a prohibited transaction, but a statutory exemption permits such payment if: (i) the services are "necessary" (in the sense of being appropriate or helpful) for plan operation, (ii) the services are provided under a "reasonable contract or arrangement," and (iii) no more than "reasonable compensation" is paid by the plan.

Effective July 1, 2012, no contract or arrangement for services will be deemed “reasonable” unless the service provider makes the applicable fee disclosures required under the 408(b)(2) Disclosure Regulation.

Fee Policy Statement

Under the DOL’s procedural guidance, there are three guiding principles for a fiduciary to follow to satisfy the fee-related duties under ERISA. [See DOL Field Assistance Bulletin 2002-3.] The principles are as follows:

- First, the responsible plan fiduciary must assure that the compensation paid directly or indirectly by the plan to its investment or service provider is reasonable.
- Second, to assess the reasonableness of such compensation, the fiduciary must obtain sufficient information regarding the fees or other compensation received by the provider.
- Third, to obtain sufficient information, the fiduciary must engage in an *objective process* designed to elicit the information necessary to assess:
 - (a) the qualifications of the provider,
 - (b) the quality of services offered, and
 - (c) the reasonableness of the fees charged in light of the services provided.

In addition, the process should be designed to avoid self-dealing, conflicts of interest, or other improper influences.

To help ensure that plan sponsors and other responsible fiduciaries are following an appropriate “objective process” designed to gather all relevant information, many are adopting as a “best practice” a fee policy statement (FPS) for their respective plans. An FPS provides guidelines for the plan to follow for purposes of managing its fees and expenses incurred with regard to service providers. It is similar to an investment policy statement (IPS), which provides guidelines concerning the management of the plan’s investment menu. As is the case with an IPS, a plan is not required to maintain an FPS. However, an FPS can serve as an effective tool to help plan fiduciaries meet their fiduciary obligations. A well-drafted FPS might include the following topics:

- The purpose of the plan and FPS;
- Fiduciary duties relating to the plan’s payment of fees;

- Roles of the plan fiduciary and service provider;
- The fiduciary review process;
- Information gathering about service providers and pricing;
- Comparing and evaluating fees;
- Bundled services considerations;
- Allocation of plan expenses; and
- Fee disclosure to participants.

Benchmarking

To evaluate the reasonableness of a provider’s fees, the responsible plan fiduciary must obtain competitive pricing information (*i.e.*, fees charged by other providers in the marketplace for similar services to similarly-sized and situated plans). Such information can be obtained by soliciting bids from multiple providers or, if this process is too burdensome, by engaging a provider of “benchmarking” services to ascertain the prevailing fees for a representative benchmark group of plans.

As a result of the strong interest in benchmarking services in the 401(k) market, many recordkeepers, third-party administrators (TPAs), and consultants now offer benchmarking to retirement plans of all types. Many plan sponsors also intend to have their respective plans (and their investments and providers) benchmarked on a regular basis (*e.g.*, every three years).

Improving Financial Literacy of Participants

The 404a-5 Disclosure Regulation imposes a new fiduciary duty on plan sponsors, requiring the delivery of a wealth of information to participants. The required disclosures must provide a side-by-side comparison of the plan’s investment options, including performance and benchmark information, as well as detailed information concerning the plan’s fees and expenses. But perhaps the most difficult obligation imposed on the plan sponsor is the fiduciary requirement that these disclosures be written in a manner calculated to be understood by the average participant. Unfortunately, if the average plan participant in a particular plan is financially illiterate, there is a good chance that these disclosures will not be understood.

To help plan sponsors avoid a fiduciary violation of the 404a-5 Disclosure Regulation, plan fiduciaries should develop an appropriate participant education strategy and arrange informational meetings designed to ensure that the plan’s participants will be financially literate and capable of understanding the mandated fee and investment-related disclosures.

ERISA Compliance Procedures for Plan Sponsors

It is important for plan sponsors to adopt and maintain a prudent process for investigating plan services and fees. The 408(b)(2) Disclosure Regulation is a timely vehicle from which much of the important information will be delivered directly to the responsible plan fiduciary.

- The review of fees for services is inextricably associated with a review of the service provider and the services themselves. Thus, the plan sponsor should focus, not only on the fee information, but on the service provider's qualifications, the scope and quality of services to be delivered, and the reasonableness of the fees in relation to those services (*i.e.*, the "value proposition").
- Plan fiduciaries must address all forms of direct compensation as well as indirect compensation payable by an investment provider or other third parties to the service provider. It is important to allocate fees among the investment and administrative services provided by the service provider, if applicable.
- If a new provider or replacement service provider is required, it is appropriate to conduct an open bid process or "request for proposal" so that comparisons may be made.
- A fiduciary review process should be conducted on a periodic basis, and properly documented with meeting minutes and correspondence.

ERISA Compliance Procedures for Service Providers

The DOL is continuing its increased enforcement efforts heading into 2014 to make sure service providers as well as plan sponsors are meeting the applicable fee disclosure requirements. For this reason, as discussed above, many plan sponsors are adopting an FPS. Similarly, many service providers are developing

formal or informal compliance policies and procedures designed to ensure that all plan clients receive their required 408(b)(2) Disclosure Regulation in a compliant time frame.

Recordkeepers and TPAs, in particular, are also developing policies and procedures designed to ensure that their plan clients' participants receive their required annual and quarterly disclosures in accordance with the 404a-5 Disclosure Regulation. Although the fiduciary duty to provide these participant disclosures is actually imposed on the plan sponsor (or other named fiduciary), plan sponsors routinely rely on their recordkeeper or TPA to deliver these disclosures on their behalf in accordance with the legal requirements of ERISA.

Conclusion

Plan sponsors have always had a fiduciary duty to evaluate fees and services on behalf of the plan and its participants. The implementation of the 408(b)(2) Disclosure Regulation has created a means by which much of the necessary information will be delivered to the plan sponsor and updated as necessary by the service provider. Plan sponsors can properly meet their fiduciary duty, in part, by having a process in place to evaluate the information provided under the 408(b)(2) Disclosure Regulation, and by providing meaningful disclosures to participants as required by the 404a-5 Disclosure Regulation. A plan sponsor should explain to participants, in advance, the 404a-5 Disclosure Regulation and the type of information that will be provided. This serves as a reminder that the plan sponsor is monitoring and staying current with all the costs of the plan and forewarns the participants of the complexity of the plan costs and fees. Ongoing and periodic communications to plan participants, as a follow-up to quarterly fee disclosures, will keep participants informed and educated as to plan expenses and enhance the review process. ■