Putting 408(b)(2) disclosure rules into practice: A guide for plan sponsors

Prepared by The Wagner Law Group

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Introduction

Plan sponsors and their service providers are becoming increasingly aware of the implications of the new 408(b)(2) disclosure rules issued by the U.S. Department of Labor (DOL). Effective July 1, 2012, all covered service providers must automatically provide comprehensive compensation disclosures to their plan sponsor clients in accordance with the requirements of Section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended (ERISA). Once plan sponsors receive these required compensation disclosures by July 1st, they in turn will need to deliver newly required “404a-5” fee disclosures to plan participants, effective as of August 30, 2012 in the case of calendar year plans.¹

Many plan sponsors correctly assume that the primary burden of providing these required disclosures falls on the service provider. But what they may not realize is that the 408(b)(2) rules and the related fiduciary requirements under ERISA also impose numerous duties on the plan sponsor. Specific duties are triggered in the event the required disclosures are defective or are not delivered on time, effectively forcing the plan sponsor to monitor and police the disclosure efforts of the plan’s various providers. Furthermore, plan sponsors in their role as the “responsible plan fiduciaries” for purposes of these rules also have an overarching duty to review these disclosures and to evaluate the reasonableness of the providers’ total compensation.

¹ The new 404a-5 fee disclosure rules impose a fiduciary duty on sponsors of retirement plans with participant-directed investments to provide certain fee- and investment-related disclosures to participants on an ongoing basis.
Plan sponsor’s 408(b)(2)-related fiduciary duties

Under ERISA’s prohibited transaction rules, plan assets may only be used to pay a provider’s fees if the service arrangement is reasonable. Under the new 408(b)(2) rules, no arrangement will be deemed reasonable unless the service provider delivers the required disclosures. In fact, unless the service provider delivers its 408(b)(2) disclosures in a manner that meets all of the applicable content and delivery requirements, the use of any plan assets to pay the provider’s fees will trigger a prohibited transaction.

In the event a prohibited transaction occurs, the service provider becomes subject to punitive excise taxes as well as civil liability and penalties under ERISA. However, the plan sponsor can also become subject to personal liability by virtue of its role as the responsible plan fiduciary and its decision to hire (or continue to engage) the provider.

A plan sponsor must never allow a plan to enter into a transaction (which would include the payment of a provider’s fees) if it “knows or should know” that such transaction will violate the prohibited transaction rules. Thus, a plan sponsor should never authorize the plan’s payment of a service fee if the provider has failed to satisfy its 408(b)(2) disclosure obligations, since any payment would otherwise result in an impermissible prohibited transaction and potential breach of the plan sponsor’s fiduciary duty. Under Section 409 of ERISA, the plan sponsor is subject to personal liability for any improper use of plan assets and any other losses sustained by the plan as a result of its fiduciary breach.

Plan sponsors have a duty to ensure that the plan’s covered service providers are providing their respective 408(b)(2) disclosures in accordance with all applicable requirements. Due to their potential liability under ERISA, plan sponsors also have a strong incentive to investigate and monitor the providers’ level of compliance with the 408(b)(2) rules.

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2 The “first tier” 15% excise tax and “second tier” 100% excise tax provisions are under Section 4975 of the Internal Revenue Code. The 20% civil penalty and related liability provisions are under ERISA Section 502.

3 ERISA Section 406(b).
Covered service providers under the 408(b)(2) rules generally fall under the following three categories:

1. Fiduciary investment managers and advisors,
2. Recordkeeping platforms and broker/dealers, and
3. Providers of other types of services that also receive revenue sharing payments or other “indirect” compensation other than from the plan or plan sponsor.

For example, the plan’s broker of record will automatically be subject to the 408(b)(2) rules, but a consulting firm that prepares the plan’s annual Form 5500 will only be subject to them in the unlikely event that it receives a referral fee or some other form of indirect compensation.

Once each covered service provider has been identified, the plan sponsor should contact each of them to confirm that they have provided or will be providing the required 408(b)(2) disclosures by July 1, 2012. The plan’s recordkeeper is subject to a further requirement under the 408(b)(2) rules, and it must deliver fee and expense information for each of the plan’s investment options (e.g., fund prospectuses and fact sheets) on an annual basis. When contacting the recordkeeper, the plan sponsor should confirm that it intends to satisfy both its own fee disclosure obligations as well as the annual disclosure requirement for the plan’s investment options.

Plan sponsors should keep in mind that the plan’s financial professional can provide critically important assistance when trying to identify and follow up with the plan’s covered providers. If there is any doubt as to whether a firm is a covered provider, the firm should be asked to confirm and explain why the firm believes that it is (or is not) a covered provider.

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Section 2550.408b-2(c)(1)(iii) of the DOL regulations. It should be noted that investment advisors to mutual funds are not covered service providers under the 408(b)(2) rules by reason of an ERISA plan’s investment in such mutual funds.
Confirming the adequacy of 408(b)(2) disclosures

After the plan sponsor has received the applicable 408(b)(2) disclosures from the plan’s providers, it should review the content of the disclosures to confirm that they are adequate for purposes of the 408(b)(2) rules. Although the content requirements are technical in nature, in sum, the provider’s disclosures must describe the following required elements:

**Services**
The disclosures must include a description of the provider’s services.

**Status as a fiduciary**
If applicable, the disclosures must state that the provider is providing its services as a registered investment adviser, a plan fiduciary or both.

**Direct and indirect compensation**
A description of all direct and indirect compensation must be included, including the identity of the payer of any indirect compensation.

**Compensation for subcontractors**
The disclosures must break out any compensation paid from the provider to third parties or affiliates acting as subcontractors to the extent such compensation is set on a transaction basis.\(^5\)

**Fees upon termination of services**
A description of any compensation payable upon termination of services must be included, as well as how any prepaid fees are refunded.

**Method of payment**
The disclosures must describe the manner in which compensation is paid, such as whether it will be invoiced or deducted automatically.

Plan sponsors have a general fiduciary duty to ensure that all plan expenses are reasonable.\(^6\) According to the DOL, if the disclosures lack “sufficient detail to enable the responsible plan fiduciary to determine whether the compensation to be received for such services is reasonable, the responsible plan fiduciary must request additional information concerning those services.”\(^7\) Thus, in addition to reviewing the disclosures for adequacy under the 408(b)(2) rules, the plan sponsor should also review them for adequacy for purposes of its general fiduciary duties.

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\(^5\) Such disclosures are also required under the 408(b)(2) rules to the extent such compensation is charged directly against the covered plan’s investment and reflected in the net asset value of the investment.

\(^6\) ERISA Sections 403, 404(a)(11) and 408(b)(2).

\(^7\) Preamble to Section 2550.408(b)-2(c) of DOL regulations.
Plan sponsor’s duty to investigate disclosure failures

If an existing covered service provider fails to provide its required disclosures by July 1, 2012, the 408(b)(2) rules require the plan sponsor to take action. It must send a written request for the delinquent provider’s disclosures immediately. Similarly, if a provider’s disclosures are inadequate and do not cover all of the required content elements under the 408(b)(2) rules, the plan sponsor must request the missing information immediately. A sample request letter is included in the attached Appendix A. This action must be taken by the plan sponsor to avoid a breach of its own fiduciary duties.

After a written request has been sent to a provider with a disclosure failure, the provider has 90 days to respond. However, if the provider affirmatively refuses or fails to reply to the sponsor’s written request within 90 days, the plan sponsor must report the provider’s continuing disclosure failure to the DOL. Depending on the particular facts, a disclosure failure may constitute a prohibited transaction that must be reported on the plan’s Form 5500 filing, even if it is corrected within the applicable 90-day period. Due to the complexity and gravity of reporting any prohibited transaction to the DOL or on a Form 5500, such action should be taken in consultation with legal counsel.

If a covered provider fails to comply with its 408(b)(2) obligations in any respect, the plan sponsor should re-evaluate the prudence of continuing the provider’s services. The question of whether a provider’s arrangement has violated (or continues to violate) the prohibited transaction rules is a serious one. If the plan sponsor has been forced to report a provider’s disclosure failure to the DOL and the provider’s services relate to future services, the plan sponsor must immediately terminate such arrangement to ensure that the plan sponsor does not breach its own fiduciary responsibilities under ERISA.
Plan sponsor’s duty to evaluate services and fees

As discussed above, plan sponsors have a duty under ERISA to ensure the fees paid by the plan to its service providers are reasonable. The plan sponsor should review all of the applicable 408(b)(2) disclosures provided by the plan’s providers, and evaluate the reasonableness of the cost of each provider’s services. All compensation information should be considered in light of the quality of the services provided, and the mere fact that a provider’s compensation is lower or higher than those of competing providers is not a determinative fact.

One of the most effective ways for a plan sponsor to satisfy its compensation-related duties under ERISA is to establish a prudent “investigative” review process for evaluating the plan’s services and compensation on a regular basis. A financial professional can provide invaluable assistance by helping the plan sponsor adopt and implement a deliberate review process. Be sure to review Legg Mason’s Fee Transparency and Best Practices for Plan Sponsors for more information on suggested processes and practices.

When evaluating the compensation of any existing service provider in accordance with a prudent review process, the plan sponsor should take into account any relevant changes made to the provider’s 408(b)(2) disclosures. Providers generally must deliver updated disclosures within 60 days after a change in the relevant information. Furthermore, with respect to any new service provider or in the event an existing provider’s services are extended or renewed, the plan sponsor should obtain and review the provider’s 408(b)(2) disclosures reasonably in advance, before making any service decisions in accordance with ERISA requirements.
Conclusion

Service providers are in the process of rolling out their required disclosures in accordance with the new 408(b)(2) rules. To avoid inadvertently breaching their own fiduciary duties under ERISA, plan sponsors should ensure that the required disclosures are delivered in a timely manner and that the content of these disclosures meets all applicable requirements. In the event that a disclosure failure occurs, plan sponsors will need to take specific action, which may include terminating the provider’s services or reporting the disclosure failure to the DOL.

To help clarify the various responsibilities that plan sponsors have in this area, we have prepared an Action Step Checklist for Plan Sponsors Under ERISA Section 408(b)(2), which is included in the attached Appendix B. Of course, plan sponsors should seek assistance from their financial professionals and legal counsel to help them navigate through the relevant ERISA rules, including without limitation those relating to their fiduciary responsibilities, as necessary.
Appendix A
Sample request letter for disclosure failures

[Letterhead of Plan Sponsor]

____________, 2012

[Covered Service Provider’s Representative]
[Title]
[Name of Covered Service Provider]
[Business Address — Street]
[Business Address — City and State]

RE: Written Request for 408(b)(2)-Related Information

Dear ______________:

In our capacity as the sponsor of the __________________________ (the “Plan”), which is subject to the requirements of the Employee Retirement Income Security Act (“ERISA”) of 1974, as amended, we have previously engaged you to provide certain services on behalf of the Plan.

It is our understanding that you are a “covered service provider” for purposes of ERISA section 408(b)(2) and the related regulations issued by the U.S. Department of Labor (the “408(b)(2) Regulations”). The required disclosures under the 408(b)(2) Regulations initially should have been provided to us by all of the covered service providers to the Plan by July 1, 2012, the effective date of the 408(b)(2) Regulations.

[ALTERNATIVE #1: We have not yet received the disclosures required by the 408(b)(2) Regulations from you.]

[ALTERNATIVE #2: We believe the disclosure you provided fails to include the required disclosures in a manner that fully complies with the requirements of the 408(b)(2) Regulations. The following information is missing from the disclosures provided:

_____________________________________________________________________________________

_____________________________________________________________________________________

We respectfully request that you provide the required disclosures as soon as practicable. If we do not receive the required information within 90 days, we will be obligated to notify the U.S. Department of Labor of this disclosure failure as required under the 408(b)(2) Regulations.

Sincerely yours,

[Plan Sponsor’s Representative]
[Name of Plan Sponsor]
Appendix B
Action step checklist for plan sponsors under ERISA section 408(b)(2)

<table>
<thead>
<tr>
<th>Critical action steps to be executed by plan sponsor</th>
<th>Already executed</th>
<th>In progress</th>
<th>No action taken</th>
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</thead>
<tbody>
<tr>
<td>1. Identify the plan’s covered service providers.</td>
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<tr>
<td>Covered providers generally include fiduciary investment managers and advisors, plan recordkeepers and broker/dealers, and providers receiving &quot;indirect&quot; compensation.</td>
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<td>2. Confirm delivery of existing providers’ 408(b)(2) disclosures.</td>
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<td>Contact each of the plan’s existing covered providers to confirm that the required 408(b)(2) disclosures will be provided by July 1, 2012.</td>
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<td>3. Confirm annual delivery of disclosures for plan’s investment options.</td>
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<td>The plan’s recordkeeper must deliver updated fee and expense information for each of the plan’s investment options. Confirm updated disclosures will be provided annually.</td>
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<td>4. Review adequacy of providers’ 408(b)(2) disclosures.</td>
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<tr>
<td>Confirm the following required elements are described in each provider’s disclosures:</td>
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<td></td>
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<tr>
<td>• Services</td>
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<td></td>
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<tr>
<td>• Direct and indirect compensation</td>
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<td>• Fees upon termination of services</td>
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<td>• Status as a fiduciary (if applicable)</td>
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<td>• Compensation for subcontractors (if applicable)</td>
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<tr>
<td>• Method of payment</td>
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<tr>
<td>5. Request missing info from any provider with a disclosure failure.</td>
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<tr>
<td>If a provider fails to deliver its disclosures by July 1, 2012 or if the disclosures are inadequate, send a written request to the provider immediately for any missing information.</td>
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<td>6. Report disclosure failure if provider refuses to provide missing info.</td>
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<tr>
<td>If the provider refuses or fails to reply to a written request for missing information within 90 days, report the disclosure failure to the DOL with the assistance of counsel.</td>
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<tr>
<td>7. Consider terminating provider’s services if disclosure failure occurs.</td>
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<tr>
<td>Consider the prudence of continuing the provider’s services if a disclosure failure has occurred. If reported to the DOL, terminate the arrangement immediately if it relates to future services.</td>
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<tr>
<td>8. Obtain and review 408(b)(2) disclosures from any new provider.</td>
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<td>With respect to any new provider or an existing provider extending its services, review the provider’s 408(b)(2) disclosures reasonably in advance of making any service decisions.</td>
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<tr>
<td>9. Use a prudent review process to evaluate provider’s services and fees.</td>
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<td>Review all disclosures and evaluate the provider’s services and fees on an ongoing basis in accordance with a prudent review process. See Legg Mason’s Fee Transparency and Best Practices for Plan Sponsors for suggestions how to establish a prudent review process.</td>
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<td>10. Review any changes and updates to 408(b)(2) disclosures.</td>
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<tr>
<td>Take into account any relevant changes made by a provider to its 408(b)(2) disclosures when evaluating the provider’s services and fees.</td>
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