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ERISA Section 408(b)(2): Is That Still a Thing?

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This article outlines the fee disclosure requirements of ERISA Section 408(b)(2) and discusses questions that remain in regard to these rules.

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Many of us who were in the retirement biz in 2012 still have nightmares about the July 1 deadline that year for fee disclosures. That deadline was the result of a then new Department of Labor (DOL) regulation that required service providers to give clear information to plan fiduciaries about the fees the provider receives from their retirement plans.

It is now more than 10 years later and those memories have faded for many, as we have since faced a multitude of later deadlines, not the least of which is the recent Third Cycle restatements. So, it probably should not surprise us that, when we are preparing or updating service agreements for our third-party administrator (TPA) and investment advisor clients, we are commonly asked if service providers are still required to provide fee disclosure documentation. Nonetheless, it startles us, as we stutter out, "Um … YES!" in response.

The July 2012 date was the original effective date of the fee disclosure rules, by which existing contracts needed to be brought into compliance. However,

the fee disclosure regulations are still in effect, and the requirement that responsible plan fiduciaries be advised in advance of entering into a service contract what fees they should expect remains applicable. We have had some clarification from the DOL in the interim, but not as much as our 2012 selves thought we would have by now.

So, let's refresh our memories about the requirements and what they mean today to service providers. Let's also talk about what remains in question about these rules.

The Main Thrust of the Rules

Fee disclosure is all about two basic concepts: (1) fees paid by an employee benefit plan for the services it requires should be reasonable; and (2) to confirm that those fees are reasonable, the responsible fiduciary must know what they are.

There are two types of required fee disclosures for retirement plans. The first goes to the decisionmaker for the plan before it hires a service provider, which permits the decisionmaker to evaluate whether the services are worth the amount being charged (that is, the 408(b)(2) disclosures). The second advises participants who can direct their own investments what their accounts are charged for both investments and services, so they can make educated choices (that is, the 404a-5 disclosures). Our discussion here is about the disclosures to the plan fiduciary, although there is a lot to say about the value (or lack thereof) in relation to the participant disclosures.

So, first, note an important fact: the fee disclosure rules deal only with fees paid for with plan assets, directly or indirectly. So, if the employer hires you and the employer is going to pay you, a fee disclosure is not required. But, if the plan is paying, or even if the employer wants to leave open the possibility that the plan will pay the fees, a fee disclosure is mandatory. Transactional fees, for distributions or loans, for example, would also qualify as fees, usually are paid out of plan assets, and therefore are subject to the disclosure.

The fee disclosure must be provided a reasonable time in advance of the date on which a service contract is entered into, extended, or renewed. Reasonable, in this instance, is at least 30 days in advance. If there is a change in the information, the change must be disclosed as soon as practicable, but not later than 60 days after the date on which the service provider knows of or is informed of the change (or, in extraordinary circumstances outside the provider's control, as soon as practicable).

The most common way for service providers to advise the plan fiduciary about their fees is with the service proposal or the service agreement when the fiduciary becomes a client. When fees change, some correspondence is provided to the fiduciary to notify it of the new fee schedule. Seems pretty easy, right?

One Important Caveat: You Must Disclose All Compensation You Are Getting

A service provider must disclose all compensation he or she receives, whether direct (that is, the plan writes you a check) or indirect (that is, someone or something other than the plan is paying you). The most common indirect compensation is, of course, revenue sharing. There was a lot of discussion in 2012 about whether revenue sharing really was compensation from the plan if it was paid by the recordkeeper or investment company from its "general assets." The DOL has been cynical about this: after all, the money got to the recordkeeper's general assets because the plan was charged fees by the recordkeeper. The applicable rule, put simply, is: if you get the money from someone other than the plan and it's related in some fashion to the plan, it's plan compensation. De minimis noncash amounts are excluded, but only if they are expected to be worth $250 or less throughout the term of the contract. How many dinners or free seminars do you need to get from a recordkeeper during the plan's lifetime before they are worth $250 or more?

Most revenue sharing is formulaic. The recordkeeper (or other payor of revenue sharing) advises the TPA that it will pay some number of basis points to the TPA for its new business and some other number of basis points for returning business. The TPA advises the client of these amounts in the fee disclosure and the client can calculate what the TPA will receive in addition to its fee charge. Similarly, financial advisor or management compensation is commonly a percentage of plan assets, paid automatically from the plan.

The TPA is also required under the DOL rules to advise the fiduciary whether it will pocket the revenue sharing as income in addition to the fees it charges directly or whether those direct fees will be offset by the revenue sharing, or if there will be some sort of partial offset. This obligation is often fulfilled half-heartedly by people who do not always offset completely. That half-hearted effort is usually noncompliant. In our experience, it is often the result of either

the payor of the revenue sharing not providing good information about what it pays and to whom or the service provider not keeping good accounting records of what it receives and why. (For what it's worth, that kind of casual attitude toward both payment and receipts amazes us, and in our experience, it amazes the DOL even more.)

What About Ad Hoc Revenue Sharing?

If it's hard to keep track of formulaic revenue sharing, ad hoc and noncash amounts are even harder.

The best example of ad hoc revenue sharing relates to incentives granted by recordkeepers to their loyal TPA partners. You may be wined and dined by the recordkeeper's representative in your region of the country. You may be invited to attend a conference put on by the recordkeeper at no cost to you. The recordkeeper may give you a budget to buy services, such as marketing materials or logo design or access to research information. These kinds of benefits vary from year to year, and you may not know at any given time if your book of business with the recordkeeper will be sufficient to earn these ad hoc rewards.

Identifying the real value of these ad hoc amounts, particularly when they are gifts and services, is very difficult. Allocating them among clients so that you can report what additional compensation you received "from" a given plan is even more challenging.

Some recordkeepers provide both a value of the noncash items they provide (at least those granted by the company itself, as opposed to one or more of its regional representatives), as well as an allocation among plans. The latter is commonly done based on the assets in a given plan, when compared to the total of the provider's book of business with the recordkeeper. So, if you have a client with $10 million in assets and you have $100 million in assets with that recordkeeper, that client is considered to have generated 10 percent of whatever compensation the recordkeeper pays you. Other recordkeepers, however, are less forthcoming with that detail, leaving the service provider with the burden of both valuing the gift and divvying it up among clients.

The Section 408(b)(2) Fee Disclosure Is Predictive in Nature: But I Don't Have a Crystal Ball

TPAs advise us: at the outset of the relationship, I don't know what revenue sharing I will receive. Ad hoc amounts are certainly not known at the outset. And, I certainly don't know what this client's "share" of that is going to be in the future.

The "unknowns" can even come from the formulaic compensation. Some types of revenue sharing require that the service provider bring or maintain a certain amount of business to qualify for the payment. Will the service provider be able to do that this year? Other types of programs increase the amount of revenue sharing when certain hurdles are achieved, such as a given dollar amount of assets under management. Again, will the provider reach this level?

As noted earlier, the ad hoc amounts may or may not come about each year, and the service provider may or may not qualify.

What if the Actual Doesn't Match the Prediction?

If a plan does its annual filing on Form 5500, it must file a Schedule C, which reflects actual compensation received by its service providers (if at least $5,000). In this manner, the plan fiduciary is informed of what it actually paid vs. the predicted assets and can ask questions.

However, there is no required after-the-fact report for those who received less than $5,000 or for smaller plans. The DOL regulations state that the service provider must disclose any "change" in the provided fee disclosure within 60 days after the provider becomes aware of the change. It is not clear, however, whether a variance from the predicted fees constitutes a "change," if the formula was the same (perhaps only the assumptions made in doing the initial disclosure varied from actual figures) or if there was no formula in the first place.

What Does the DOL Want?

In an extensive DOL investigation of one of our TPA clients, and the recordkeeper with which it worked in 2020, we asked these questions to the DOL investigators. It became quickly apparent that the investigators had no idea what most recordkeepers provide to the TPAs regarding both formulaic and ad hoc revenue sharing. They were also surprised that the TPA being reviewed did not assiduously account for every dollar due and received from the recordkeepers. While they knew they wanted to make sure that the fee disclosure was comprehensive and accurate, they really didn't know what was in the realm of possibility nor what they desired within that realm.

When asked what they wanted to see, the investigators pointed out that they were enforcers of the rules,

not the drafters of the regulations. Therefore, they could not speak definitively as to what the monolithic DOL wanted from the TPA community. They did not seem to appreciate the irony that, if they didn't know what they wanted, the TPA certainly did not know for sure if she complied or not. And, for what it was worth, neither could the recordkeeper.

In this particular investigation, we and the investigators agreed on a method of both predictive disclosure for new clients and annual reporting to existing clients that would provide enough detail for the investigators to be comfortable. However, we emphasized to the investigators that not every recordkeeper would give the information that the company under investigation provided, and not every TPA has a system to retain the detail that the TPA under investigation was able to accommodate.

What is the status of the DOL's position on reporting revenue sharing? It is not clear. As the investigators reminded us several times, they do not make the regulations, they simply enforce them. The actual regulations are not clear about the detail required, which makes this whole thing unnecessarily difficult.

What Happens if You Don't Comply with Fee Disclosure?

The fee disclosure rules are housed in the prohibited transaction exemption of the Employee Retirement Income Security Act of 1974, as amended (ERISA), the Internal Revenue Code (the Code or IRC), and the DOL regulations. A service provider is a party-in-interest to a retirement plan and cannot be paid for those services under the prohibited transaction rules unless an exemption to those rules applies. That exemption is in ERISA Section 408(b)(2), which permits a service provider to contract with the plan if the contract and the fees are reasonable. The DOL regulations that first became effective in 2012 stated that, if proper fee disclosure is not made, the contract is per se unreasonable, and there is a prohibited transaction. [Labor Reg. § 2550-408b-2(c)(1)(i)]

If the contract is a prohibited transaction, the service provider is required to pay a 15 percent excise tax on the amount of the fees paid. This amount increases to 100 percent if the prohibited transaction is not corrected. [IRC § 4975(a), (b)] The correction must, pursuant to Code Section 4975(e)(5), undo the transaction to the extent possible and put the plan back into the financial position in which it would have been had the prohibited transaction not occurred. This correction presumably requires the service provider to disgorge the fees paid.

The plan fiduciary is also considered to have participated in the prohibited transaction. The DOL regulations require that, if fee disclosure is not received, that the plan fiduciary demand it from the service provider. If the fee disclosure is still not provided, the plan fiduciary has two obligations: (a) notify the DOL that the service provider has not given it the fee disclosure, using the following website: *https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/fiduciary-responsibilities/fee-disclosure-failure-notice*; and (b) fire the service provider. If the fiduciary does not comply with these requirements, it is potentially liable for a breach of its duties under ERISA.

So, both the service provider and the plan fiduciary are both encouraged by these regulations to ensure that proper fee disclosure occurs.

What Do We Suggest?

Let's be clear at the outset about our opinions and our advice to clients about fee disclosure. Plan fiduciaries should know what they are being charged and they should make sure it is reasonable. And service providers should know what they are getting, should give that information to the plan fiduciaries, and should have the integrity to believe that it is fair compensation for what they do. So, fee disclosure is appropriate and should be done. If that, in itself, is not enough to get a service provider to engage in proper disclosure, the potential penalties for not doing should convince him or her to follow the law.

Having said that, it is hard for service providers to know exactly what is "right," even if their intentions are pure. The accounting burden caused by revenue sharing is not insignificant, and it is uneven depending on the procedures used and reports generated by the recordkeepers and other payors of revenue sharing. If detailed reports are provided regularly, it should be manageable for the service provider to track and report it to its clients. On the other hand, ad hoc payments and payments in noncash rewards may not be reported in a manner that enables the service provider to easily know the amount of the compensation or how to allocate it among clients. Amounts are not necessarily predictable from year to year, so it is hard to disclose them in advance, as is required by the regulations.

If possible, it is best to:

1. Estimate reasonably what you expect to get in relation to a plan at the outset of the relationship,

and disclose this as part of your proposal and/or service agreement, before the client "signs on," as is required by the regulation. If you do a lot of work with this recordkeeper, you should have some ballpark sense of what you are going to get paid. If you don't do a lot of work with this recordkeeper, perhaps talk to your regional contact to see what s/he would predict.

2. Review predictable amounts when they are received to ensure that they align with any contract you have with the revenue sharing provider and can attribute the amount received to each client based on any applicable formula.
3. Review ad hoc amounts and noncash amounts when received, request the equivalent value from the payor of such amounts, and allocate those amounts among your mutual clients in a reasonable manner, such as per plan or based on the plan's assets on deposit with the payor of the revenue sharing.

If you cannot do these things, you need to reconsider whether you should accept revenue sharing from that source. Some practitioners avoid all the accounting complications by just saying no.

If you decide to continue to accept revenue sharing and either cannot obtain the reporting necessary to follow the above steps or do not want to spend the time or energy to do so, understand the risk that you are taking. While the DOL has not been particularly visible investigating these issues and enforcing the regulations, litigators are certainly doing so. And, it is always possible that the DOL will make this an enforcement priority in the future. You must consider whether you really want to run the risk that the DOL might require you to disgorge fees and pay excise taxes on amounts if it investigates your practices.

And, one more thing: under no circumstances should you be providing services to retirement plans and their sponsors without a written service agreement. This agreement can be the vehicle for the compensation disclosures that are discussed in this article, as well as evidencing the exact services you will provide. While there are many, many other reasons to have a written agreement, the ability to demonstrate clarity of the services you are providing, and the fees charged for those services goes a long way to meet the disclosure rules discussed in this article. ■