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Impact of the 408(b)(2) Regulation on TPAs

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On July 16, 2010, the US Department of Labor (DOL) issued an “interim final” regulation under ERISA Section 408(b)(2) that requires most service providers to ERISA-governed “pension”¹ plans to provide written disclosures to plan fiduciaries before they enter into, renew or extend contracts or arrangements to provide their services.² As described in more detail later in this article, the new regulation applies to third party administrators (TPAs) unless their compensation is received only from the plan sponsor or the plan. That is, if a TPA receives indirect compensation, it is a “covered” service provider.

To put the new regulation in context, ERISA section 406(a) prohibits the provision of services to plans unless an exemption applies. An exemption is available under section 408(b)(2) if:

- the services are necessary for the establishment or operation of the plan;
- the arrangement between the service provider and the plan is reasonable; and
- the compensation paid to the service provider for the services is reasonable.³

The purpose of the new regulation is to provide guidance on what steps a service provider must take in order for its arrangement with a plan to be considered reasonable and thus not a prohibited transaction.

This article focuses on the impact of the regulation on covered TPAs that do not provide recordkeeping services, are not producing TPAs or are not affiliated with brokers, unless specifically mentioned. These are referred to as “independent” TPAs.



Discussion of the New Regulation

The 408(b)(2) regulation requires “covered service providers” that provide services to “covered plans” to disclose the terms of the arrangement in order to give the “responsible plan fiduciary” sufficient information to determine whether the arrangement is exempt from the prohibited transaction restrictions.⁴ A person providing services to a plan is presumed to have engaged in a prohibited transaction under ERISA section 406(a) unless he or

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- 1 For practical purposes, under ERISA, “pension” plans include all private sector tax qualified retirement plans that cover at least one common law employer. In addition, that includes any private sector 403(b) plan that is subject to ERISA’s provisions.
- 2 For the sake of simplicity, we will refer to these as “arrangements,” since the statutory exemption and the regulation relate to service arrangements and do not require formal contracts between the parties.
- 3 There are parallel provisions in the Internal Revenue Code, but for the sake of simplicity, this article focuses on the ERISA provisions.
- 4 ERISA Section 406(a)(1) says that a “fiduciary with respect to a plan shall not cause the plan to enter into a transaction, if he knows or should know that such transaction constitutes a direct or indirect... (C) furnishing of goods, services or facilities between the plan and a party in interest.” Section 408(b)(2) provides the exemption from this prohibition. Even though the focus is on the fiduciary, under the new regulation, the party charged with engaging in the prohibited transaction for failure to make adequate or proper disclosure is the service provider.

Even if an independent TPA is providing plan administration services, they will be covered by the regulation only if they receive indirect compensation.

she can prove that there was an exemption for the transaction (e.g., the services and the compensation for those services). That is, the burden will be on the service provider to prove that it complied with the regulation, and the failure to fulfill the disclosure obligations in the regulation will cause the service provider's engagement to be a prohibited transaction. Consequently, the service provider will have to restore to the plan the "amount involved," plus interest.

Impact: Although it may vary based on the type of disclosures that were not made, the amount involved will likely be all of the compensation received by the TPA. An excise tax may also be imposed under the Internal Revenue Code, and if the DOL recovers the money for the plan, an additional 20% penalty may be imposed.

Applicability

Covered Plans

The regulation applies to "covered plans" (i.e., all ERISA-governed retirement plans other than SEP IRAs and SIMPLE IRAs). (Individual retirement accounts are excluded since they are not ERISA plans.) Thus, 401(k) plans, ERISA-covered 403(b) plans, defined benefit pension plans and non-participant directed profit sharing plans, among others, are subject to the regulation. [Generally, this article will focus on the application of these rules to participant-directed 401(k) and ERISA-covered 403(b) plans.] It appears that non-ERISA tax-qualified plans, such as plans that cover only the business owner and his or her spouse, are not covered plans.⁵

Comment: While several categories of plans are not covered by the regulation, such as governmental and non-ERISA 403(b) arrangements and plans subject to the Internal Revenue Code that are not subject to ERISA, service providers—even non-covered service providers—may find that the new regulation becomes a standard for all of their clients. There are several reasons for this effect:

- First, the ERISA and Code statutory prohibitions apply to plans, service providers and circumstances even if they are not covered by the regulation—but other than the new regulation, there is no guidance for disclosure in non-covered cases. Thus, even though the specific requirements of the new regulation do not apply, courts may apply some or all of its criteria in determining whether a prohibited transaction exists to non-covered situations.

- Second, service providers that serve multiple markets may find it more cost-effective and efficient to establish one disclosure regimen rather than trying to determine when the disclosures are required and when they are not.
- Third, the disclosures required by the new regulation could become the expectation of consultants and fiduciaries in all cases, regardless of whether they are covered by the regulation.
- Finally, in the case of government plans, the laws of some states are virtually identical to ERISA, and it is not hard to imagine that a state court might look to ERISA and the regulations under ERISA to determine compliance with the state law.

Covered Service Providers

The regulation applies to "covered service providers" that reasonably expect to receive \$1,000 or more in direct or indirect compensation (apparently over the life of the contract, though this is not altogether clear) and that provide "covered services." Among the covered services are administration services to plans so long as the service provider receives indirect compensation (discussed later in this article). Even if an independent TPA is providing plan administration services, they will be covered by the regulation only if they receive indirect compensation. (This provision assumes that the TPA is not serving in a fiduciary capacity, which is generally not the case.)

Impact: The final regulation reflects a significant change from the proposed regulation. Under the original proposal, all TPAs would have been required to comply with its requirements regardless of the source of their compensation. Under the final regulation, only those that receive indirect compensation must comply. Since, in our experience, many TPAs do receive indirect compensation, this change may not be a material change and they will still need to comply with the new rules.

Specific Requirements

Disclosure Must Be in Writing

The regulation requires a covered service provider to disclose specified information to the "responsible plan fiduciary" (a defined term) in writing. While the proposed regulation specified that there had to be a written contract or arrangement between the plan and the service provider, the "contract" requirement has not

been carried over into the final regulation. That said, there is still a requirement for providing the required disclosures in writing, and it may be sensible for covered service providers to use a written contract to do so.⁶

Impact: In our experience, most independent TPAs already use a written service agreement. Adding the required disclosures to the contract may be an effective way to provide the disclosures rather than developing a separate written disclosure notification. In addition to the elimination of having to track two separate pieces of documentation, the TPA will be better able to prove compliance if the disclosures are in the contract signed by the client. Further, a written service agreement detailing the services the TPA will provide, describing any limitations on those services, spelling out their compensation and specifying remedies and limitations on their liability for errors would be prudent from a risk management perspective.

Timing of Disclosures

The disclosures required by the regulation must be made to the responsible plan fiduciary *before* the fiduciary agrees to hire the service provider or to renew or extend its contract. For contracts with fixed terms, such as those that expire every year, service providers would need to make these disclosures every time they enter into a new contract or renew the existing contract. The one exception to this rule is for existing clients between now and the effective date of the regulation—what we refer to as the “transition period.” For those clients, the disclosures need to be made no later than the effective date.

Impact: The responsible plan fiduciary is identified as the person or entity that has the authority to make decisions about the hiring of service providers, such as the TPA, on behalf of the plan. Typically, that would either be the plan sponsor with capacity as the primary plan fiduciary (that is, as the Plan Administrator) or, if the plan sponsor has appointed a committee, it would be the committee (or one of its members).

Compliance Effective Date

The proposed regulation applied only to new, renewed or extended arrangements entered into after the effective date of the rule. The final regulation requires that covered service providers comply with the disclosure requirements for *all* covered plans by July 16, 2011, even if the arrangement is entered into prior to that date and even if it is not being extended, renewed or

modified. Thus, there are no “grandfathered” clients to whom the disclosures will not need to be made, and covered service providers will need to give the disclosures to all of their clients, in addition to establishing procedures for complying in the future for new clients.

Impact: Because the disclosures must be made to all clients no later than July 16, 2011, the new regulation effectively creates a “transition period”—that is, the period between now and the compliance effective date. Thus, TPAs will need to decide on the approach for how to comply for the clients to which they provide services as of the effective date (*i.e.*, the “transition” plans) and, potentially, a second approach for new clients acquired after the effective date.

One approach may be to prepare a disclosure notice to be given to transition plan clients and have a modified service agreement for use in the future. Another, possibly more efficient approach may be to develop a new service agreement containing the disclosures now and begin using it with all clients. In that way, they may convert all of their clients to the new regime before the July 16, 2011 deadline. Further, even if all of those clients do not sign and/or return the new service agreements, they will nonetheless have been given the written disclosures (because of the delivery of the proposed agreements). Some of our TPA clients have elected this latter approach and will be sending the new agreement out to all existing clients when they request the year-end data for their clients’ plans.

Services

The regulation requires the covered TPA to describe the services it will provide under the contract. The regulation does not specify how the services are to be described, indicating only that the level of detail will vary depending on the needs of the responsible plan fiduciary. The format of the disclosure is not specified, though the DOL has requested comments on whether it should amend the regulation to require service providers to give a short (*i.e.*, one or two-page) summary disclosure to serve as “a roadmap for the plan fiduciary describing where to find the more detailed elements of the disclosures required by the regulation.” (See Preamble to the interim final regulation.) For TPA clients who want to take a conservative approach, we have added a summary and roadmap to their new service agreements. This summary and roadmap can be used as a cover page for the agreement.

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6 While the regulation is silent on whether electronic disclosures satisfy the “written” requirement, there is language in the preamble supporting the use of electronic communication.

Impact: TPAs could probably describe their services as consulting and third party administration services. In our experience, TPAs that currently use service agreements already spell out their services in considerable detail. Indeed, from a risk management perspective, we believe this is important to describe what services the TPA will provide—and the services that it will not provide. For example, TPAs who will not evaluate controlled group issues or perform top heavy testing, unless specifically requested to do so, should state this in their contracts.⁷

Note that if a TPA provides certain other services (e.g., recordkeeping or brokerage services) in addition to its administration services, additional disclosures would be required. Discussion of these items is beyond the scope of this article.

Compensation

The covered service provider must describe the direct and indirect compensation to be received by the service provider and its affiliates and subcontractors. Direct compensation means “compensation” (i.e., anything of monetary value, such as money, gifts, awards and trips, but excluding non-monetary items of \$250 or less received during the term of the contract or arrangement) that is received directly from a plan. Indirect compensation is “compensation” that is received from any source other than the plan, the plan sponsor, the covered service provider, an affiliate of the service provider or a subcontractor of the service provider. Note that compensation paid by the plan sponsor is neither direct nor indirect and thus is not technically required to be disclosed.

For indirect compensation, the regulation also requires identification of:

- the services for which it will be received; and
- the payer of the indirect compensation.

The latter requirement—identification of the payer of the indirect compensation—is a new requirement, not found in the proposed regulation. Effectively, this requirement partially replaces the somewhat unworkable provision of the proposed regulation to disclose relationships and describe conflicts of interest.

Note that the definition of compensation includes both money and “any other thing of monetary value.” For non-monetary items, the proposal does not specify how to disclose the value or cost. However, as a general premise, service providers must disclose compensation as a dollar amount, a formula based on plan assets, a

per participant charge or all of the above. Note, too, that the requirement includes compensation received by affiliates and subcontractors of the service provider.

The regulation also requires that a service provider disclose the manner of payment (e.g., whether it will bill the plan, deduct fees from plan accounts or be charged against the plan investments).

Finally, there is a requirement to disclose any compensation the service provider reasonably expects to receive in connection with termination of the contract (e.g., a surrender charge) and how prepaid amounts will be calculated and refunded upon termination of the contract (for example, if a TPA charges in advance for the year and the arrangement is terminated before all services have been provided).

There are a number of additional disclosures applicable to recordkeepers, brokers and certain plan fiduciaries (that manage certain types of investments in which a plan may invest), but those requirements would not ordinarily be applicable to independent TPAs and are not discussed in this article.

Impact: The new regulation is somewhat schizophrenic in its requirements regarding the disclosure of compensation. On the one hand, a TPA is a covered service provider only if it receives indirect compensation. On the other, once it is considered a covered service provider, it must disclose all of its compensation, both direct and indirect, as well as the manner of receipt (i.e., whether the plan will be billed, the payment will be taken out of plan assets or whether it will be paid by a third party) and, in the case of indirect compensation, the source of the funds (i.e., the payer) and the other items outlined above.

In our experience, TPAs that use a service agreement do a good job of describing their direct compensation and the services to which it applies. Indeed, many contracts are extremely detailed in the listing of fees for specified services. The impact of the new regulation will most likely be found in connection with the indirect compensation they receive—often in the form of payments from providers or investments based on new business or persistency of existing business, regardless of how the payments are labeled. While many TPAs may disclose the receipt of “revenue sharing” in a generic way, they may not provide the detail required by the new regulation. That is, they will now need to describe the services for

which the compensation is being received, the amount or formula for determining the amount of the compensation, and the source (*i.e.*, the payer) of the payment with respect to the specific plan to which they are providing services. Indeed, if the compensation is contingent on meeting certain goals, the TPA will likely need to disclose the criteria for determining whether they will become eligible for the compensation. (While the regulation specifically permits formulas to be used to describe compensation, it also requires that the disclosure enable the responsible plan fiduciary to evaluate the reasonableness of the compensation. As a result, it is possible that the qualification criteria and the formula for compensation could be so vague or produce such a great range of compensation that it failed to satisfy that standard.)

While the regulation requires only disclosure of indirect compensation, as a practical matter a plan fiduciary may, once they understand the payments are derived from their plans, want the indirect compensation offset against the TPA's bills to the plans. It is possible that this change will lead TPAs to bill those clients under the regular fee schedules and then apply the revenue sharing against those bills on a dollar-for-dollar basis.

In our experience, the requirement regarding termination payments and prepaid amounts will have varying impacts, because most TPAs do not impose a termination charge, but some receive advance payment for their administration services. Under the new regulation, there is no problem with receiving payment in advance, but TPAs who use this approach will need to include a description of the proration and refund of the advance payment if the contract is terminated before the entire advance payment is earned.⁸

Fiduciary Status

The regulation requires a service provider to disclose whether it, or an affiliate or subcontractor, will provide any services to the plan as a fiduciary as defined under ERISA § 3(21)(A) or as an investment adviser registered under the '40 Act (or state law). If both, then both must be disclosed.

Impact: Since the services provided by TPAs rarely give rise to fiduciary status, independent TPAs (and even those that provide non-fiduciary recordkeeping or brokerage services) will not need to comply with this requirement. However, in our view, from a risk management perspective, TPAs should specifically state that they are *not* fiduciaries in order to clarify the nature of the relationship at the outset and avoid confusion in the mind of the client.

Changes in Information

A service provider must disclose any change to the required information as soon as practicable, but in any case no later than 60 days from the date on which the service provider acquires knowledge of the change. Note that there are two changes in this requirement from the proposed regulation:

- the requirement that the change must be “material” has been dropped; and
- the time period has been extended from 30 to 60 days.

There is a provision that allows for additional time in extraordinary circumstances, but probably should not be relied upon unless absolutely necessary.

Impact: This requirement should have little impact on TPAs except in two contexts. The first is when a TPA wants to change fees. In those cases, a TPA will need to take steps to disclose the change in their fee structure within 60 days of deciding to make the change. The second is in the case of indirect compensation that may be paid only if the TPA meets an eligibility requirement. TPAs would appear to have two alternatives to complying in this case. One way would be to wait to disclose, that is, to wait until they qualify and then make a change disclosure regarding the additional compensation they will receive under the 60-day rule. The drawback to this approach is that it will require additional disclosures and administrative attentiveness—a failure to give the change notice can cause the arrangement to become a prohibited transaction. Further, this approach might not comply with the requirements of the regulation, since it requires that the service provider disclose amounts it reasonably expects to receive. The second approach is to disclose the conditions and the formula in advance and then provide a change disclosure once the TPA qualifies.

In the context of changes to their fee structure (or other changes to the contract), TPAs need to exercise caution. The concern here is based on a position taken by some DOL officials that if a service provider can set its own compensation, it is exercising control over the plan or plan assets and is thus a fiduciary (at least to that extent). That status gives rise to a host of other issues and potential problems for the TPA. To avoid this situation, a TPA might send out a proposed amendment to its service agreement and ask that the client sign and return it. If the client fails to return the amendment, the change in fee structure would not go into effect. Alternatively, a TPA could build into



⁸ It is not clear that the regulation requires a refund of prepaid amounts, though the wording seems to contemplate that refunds will be made. This interpretation is possibly because under Section 408(b)(2), a service provider's compensation must be reasonable, and if unearned amounts are retained, the overall compensation might not be considered reasonable.

its service agreement and make use of the “Aetna” process, which is derived from DOL Advisory Opinion 97-16A. Under this approach, the TPA would provide notice of the change to the client 60 days in advance of the effective date of the change and advise the client that unless the client objects to the change within that time, it will be deemed to have approved the change. With this approach, the TPA avoids setting its own compensation because the client has effectively approved the change through its failure to consent.

Reporting and Disclosure Information


The regulation requires a service provider to disclose, upon written request, any other information relating to compensation received in connection with the arrangement, if it is required for the plan to comply with the reporting and disclosure requirements of ERISA and its regulations, forms and schedules. The information must be provided not later than 30 days after receipt of a written request from the responsible plan fiduciary or plan administrator (unless the disclosure is precluded due to extraordinary circumstances beyond the service provider’s control). In that case, the information must be disclosed as soon as practicable. This situation would arise most often in the context of reporting information on Schedule C to the Form 5500 for large plans (*i.e.*, plans with 100 or more participants), but the requirement is not limited to that Schedule or Form.

Impact: This condition should have little impact on TPAs that serve the small plan market, but it could affect TPAs that work with larger plans.

Disclosure Errors

The final regulation includes a welcome addition: it specifies that no arrangement will be considered unreasonable (*i.e.*, a prohibited transaction) solely because the service provider makes an error or omission in disclosing the information, so long as two requirements are met. First, the service provider must have been acting in good faith and with reasonable diligence; second, the service provider must disclose the correct information to the responsible plan fiduciary as soon as practicable, but not later than 30 days from the date on which the service provider knows it made the error or omission. This will protect service providers from innocent mistakes that otherwise could have caused their arrangement to be a prohibited transaction.

Conclusion

The regulation is designed to increase the amount of information received by fiduciaries about their service providers. For TPAs who already use service agreements and who provide information about indirect compensation to plan sponsors, the changes will be relatively minor. Alternatively, TPAs who have not used service agreements or disclosed indirect compensation will be required to make significant changes to comply with the regulation. However, once the agreements and systems are put in place to comply with the regulation, the new rules should not have a significant impact on the operations of TPA firms. 



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