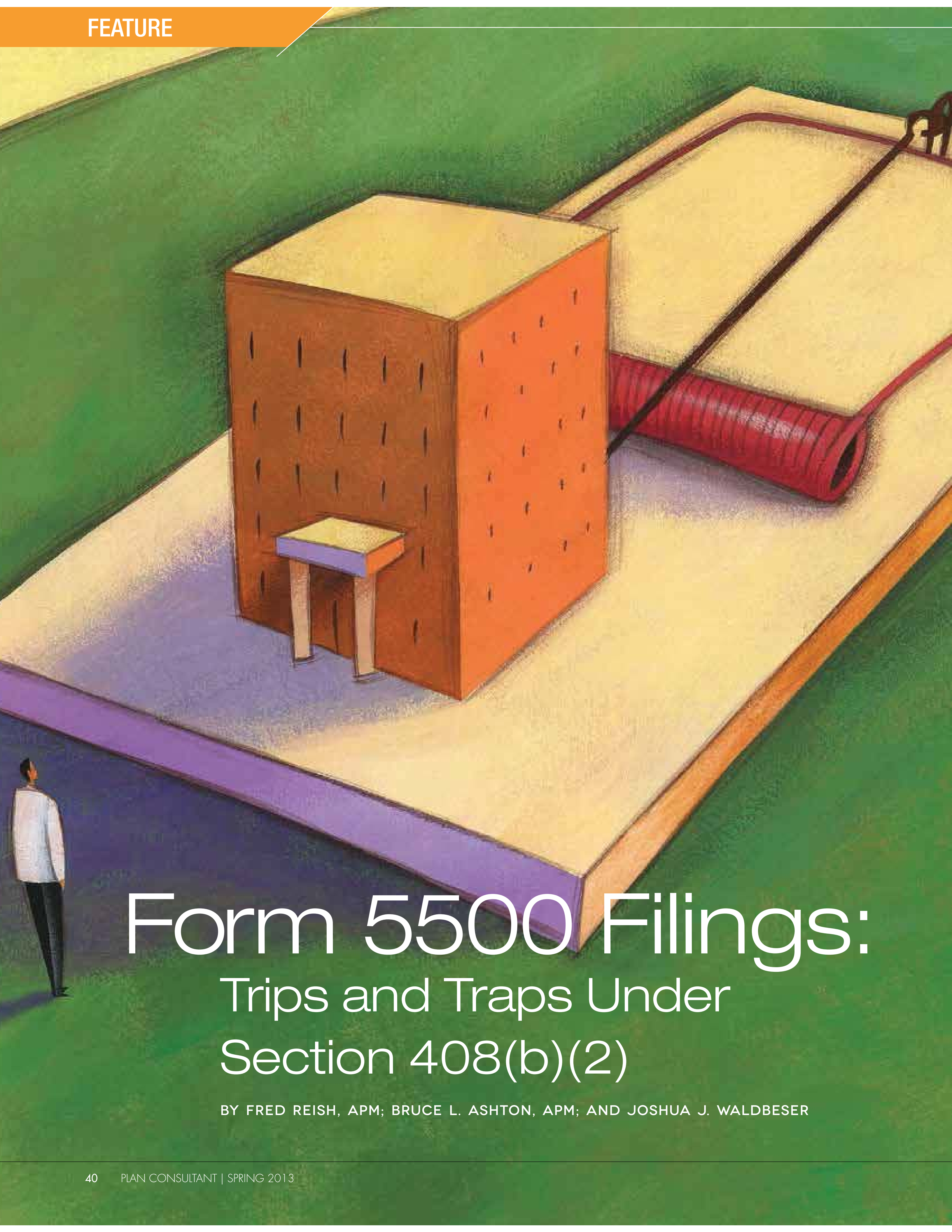

Form 5500 Filings:

Trips and Traps Under Section 408(b)(2)

BY FRED REISH, APM; BRUCE L. ASHTON, APM; AND JOSHUA J. WALDBESER

When dealing with 408(b)(2) issues, here's how record keepers, TPAs and auditors can provide a valuable service to their plan sponsor clients and, at the same time, protect themselves from exposure to malpractice claims by those clients.

The ERISA Section 408(b)(2) disclosure requirements may contain an unpleasant surprise for record keepers and TPAs (which we'll refer to as "preparers"). That surprise—an obligation related to the 408(b)(2) disclosures received by their clients—will create issues for preparers unless properly handled.

Much has been written about the disclosure obligations of covered service providers (CSPs) under the 408(b)(2) regulations,[1] and the obligation of plan sponsors to determine if the information is adequate.[2] This article does not repeat those discussions; rather, it addresses how the disclosure requirements affect Form 5500 preparation, including financial audits for plans with 100 or more participants.[3]

There are four key ways in which Form 5500 preparation is affected by the 408(b)(2) disclosures:

1. Prohibited transactions must be reported on the Form unless an exemption is available.[4] Failure by a CSP to make the required 408(b)(2) disclosures is a prohibited transaction, and there is no exemption. Thus, this service provider prohibited transaction has to be reported on the Form 5500.
2. Plan sponsors, in their role as fiduciaries, engage in a prohibited transaction if the disclosures are inadequate and the fiduciary fails to take specific actions. Though there is an exemption under the 408(b)(2) regulation, it may not be available. If the exemption is not available, this fiduciary prohibited transaction would also need to be reported on the Form 5500.
3. In large plans, service provider compensation of $5,000 or more must be reported on the Schedule C unless it qualifies as "eligible indirect compensation." To fall into that category, advance disclosures have to be made by the CSP.
4. Auditors need to certify the financial information on the 5500, including the existence of prohibited transactions.

What all these have in common—and thus the problem for preparers—is that plan sponsors generally look to the record keeper or TPA to prepare the Form 5500 and obviously look to the CPA to prepare the audited financials for the plan, but these service providers may not know: (1) whether the disclosures have been made, (2) whether they were made by all required CSPs, and (3) whether they are adequate. This means that the preparer needs to have a process for verifying whether and how well the required disclosures have been made.

In this article we discuss these issues and the ways that, in dealing with these issues, record keepers, TPAs and auditors can provide a valuable service to their plan sponsor clients and, at the same time, protect themselves from exposure to malpractice claims by those clients.

REPORTING PROHIBITED TRANSACTIONS

All plans are required to indicate on their 5500 Form whether there were "any nonexempt transactions with any party-in-interest" during the preceding plan year. The requirement to answer this question on the form is far from academic—the plan administrator is required to sign the form under penalties of perjury, certifying that "to the best of (its) knowledge and belief, [the filing] is true, correct, and complete." If this is not the case, because there were unreported prohibited transactions, the filing can be rejected—leading to late filing penalties—and the plan administrator can be subject to penalties for filing a false report.[5]

This is especially relevant for the 2012 Form 5500 because 408(b)(2) is an exemption from a prohibited transaction. For the exemption to be available, CSPs are required to make specific disclosures. Failure by the CSP to make those disclosures means

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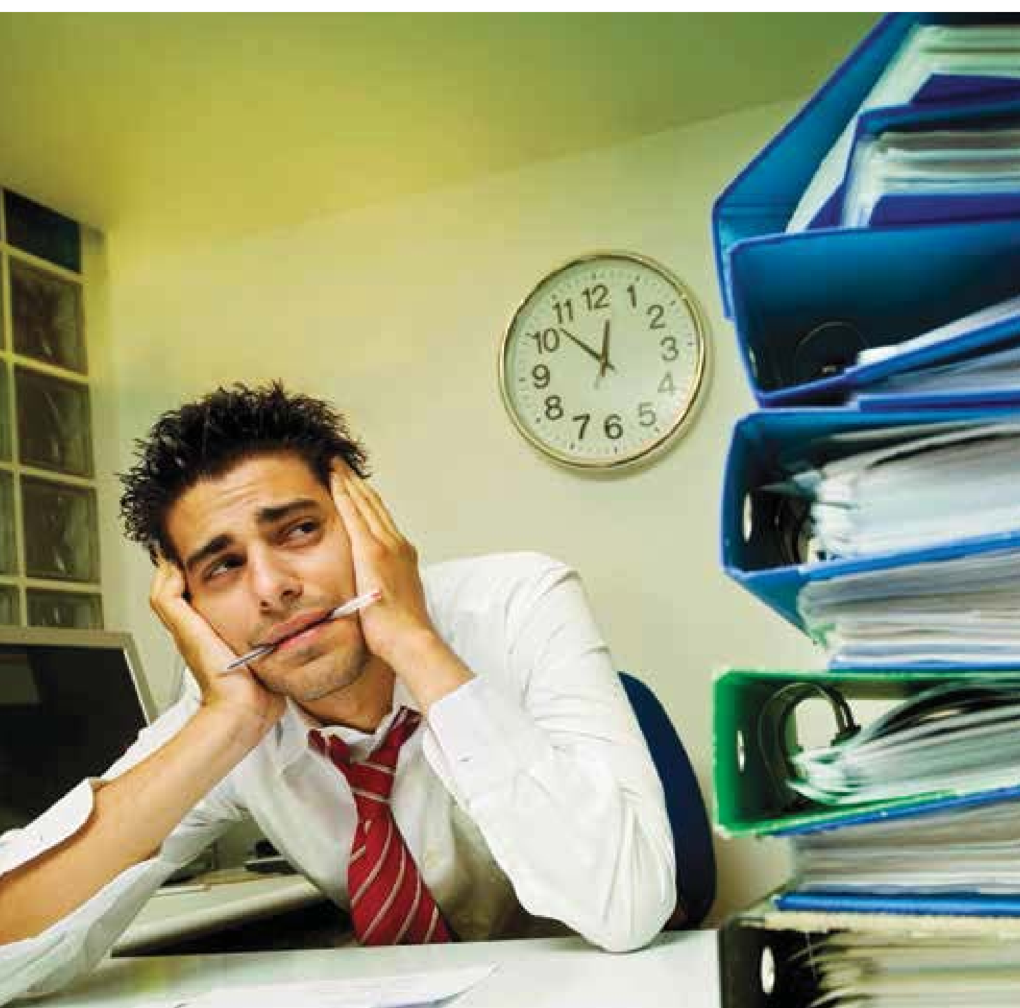
[1] 29 CFR §2550.408b-2.

[2] The plan sponsor or its plan committee have the responsibility for receiving and reviewing 408(b)(2) disclosures in the capacity of the "responsible plan fiduciary," and they are also responsible for signing the Form 5500 as the plan sponsor and administrator. Throughout this article, the authors refer to these parties generally as "plan sponsors" for ease of reading.

[3] The audit requirement applies to plans with 100 or more participants at the beginning of the plan year being reported on, except that a plan with between 80 and 120 participants can avoid an audit so long as the filing is consistent with the immediately preceding plan year's filing. We refer to 100+ participant plans for convenience as "large plans."

[4] For large plans, the transaction is disclosed on Line 4d of Schedule H, and it is then described in Part III of Schedule G. For small plans, the transaction is disclosed on Line 4d of Schedule I, or on Line 10b for plans that file Form 5500-SF.

[5] See also Instructions for Form 5500, "Penalties" at p. 7.



from existing CSPs. In essence, this question encompasses three issues:

- whether disclosures were received from all covered service providers;
- whether those disclosures were adequate—that is, they complied with the requirements of the 408(b)(2) regulation; and
- if they did not comply with the requirements of the 408(b)(2) regulation, whether the plan sponsor took steps to obtain adequate information.

(Of course, the disclosure obligation also applies to any new service engagements or renewals or extensions of existing arrangements going forward after June 30, 2012.)

If a covered plan has not timely received 408(b)(2) disclosures from all of its CSPs, or if any of those disclosures are inadequate, the resulting prohibited transaction must be reported. This requirement applies regardless of whether the arrangement is reasonable and the compensation of the service provider is reasonable. In this case, no exemption is available with respect to the service provider and its arrangement with the plan.[7] And if the plan sponsor has not taken steps to correct any deficiency in the disclosures, it too has engaged in a prohibited transaction that would need to be reported.

that it has engaged in a prohibited transaction. The DOL is already beginning to ask for the disclosures in its investigations and will doubtless begin investigating in earnest after the 2012 calendar year Form 5500s are filed.

There is also a second potential prohibited transaction. In the 408(b)(2) regulation, the DOL provided an exemption from the prohibited transaction rules for the responsible plan fiduciary (for these purposes, we assume this is the plan sponsor). But in order for this exemption to be available, the plan sponsor must determine whether it has received the required disclosures. As the DOL states, the plan sponsor must have "a reasonable belief that disclosures … are complete. Fiduciaries should be able to, *at a minimum*, compare the disclosures they receive from a covered service provider to the requirements of the regulation and form a reasonable belief that the required disclosures have been made."[6] (Emphasis added.)

Failure to take the steps needed to form this "reasonable belief" means that the plan sponsor has also engaged in a prohibited transaction. (Assuming the plan sponsor asks for the missing or incomplete information, if it does not receive it within 90 days, the plan sponsor must terminate the service provider. Failure to do so is a fiduciary breach, though not a prohibited transaction and thus not a reportable event on the Form 5500.)

Thus the question on the Form 5500 regarding "non-exempt transactions with a party in interest" will impact all filers with a plan year that includes July 1, 2012—the required due date for disclosures

The Preparer Problem

Plan sponsors in the small- and mid-sized plan markets generally look to one of their providers, *i.e.,* the record keeper or TPA, to prepare the Form 5500. In most cases, the record keeper or TPA prepares the 5500s and either sends them to the plan sponsor or posts them on a secure website for the plan sponsor's review and approval. If the preparer has made assumptions about the answers on the form—*e.g.,* that there were no prohibited transactions—the form may be wrong

[6] See Section 9 of the preamble to final 408(b)(2) regulation, titled " Exemption for Responsible Plan Fiduciary" at Fed. Reg., Vol. 77, No. 23, p. 5632 (Feb. 3, 2012).

[7] Two of the authors, Fred Reish and Bruce Ashton, and Bradford Campbell, have submitted a proposal to the Department of Labor for a correction program covering failures by CSPs to make timely 408(b)(2) disclosures in cases where the failures are inadvertent.

or incomplete. In that case, the plan sponsor bears a legal risk, and the preparer will probably get the blame.

The problem for preparers is that they will not generally be in a position to know whether all of a plan's CSPs have provided adequate 408(b)(2) disclosures. Were 408(b)(2) disclosures furnished by all CSPs who had to furnish them? Were they timely? Were they adequate? And if not, did the plan sponsor take the required steps to obtain correct information?

> "Record keepers, TPAs and auditors who prepare or audit Forms 5500 should consider taking on a more proactive role in protecting their plan sponsor clients—and in mitigating their own risk for incorrectly preparing or auditing Forms 5500."

The answer is that preparers need to ask. That said, knowing what to ask is the hard part—see "Preparer Procedures" below for some steps a preparer can take.

SCHEDULE C REPORTING

Large retirement plans are required to file Schedule C with their Forms 5500, which discloses information about the plan's service providers that receive $5,000 or more in direct and indirect compensation during the reporting year. Part I of Schedule C requires that the direct and indirect compensation be broken out separately.[8] In addition, the services for which the compensation was received, and relationships between the provider and the employer (or another party-in-interest) must be described.[9]

There is an alternative reporting mechanism for providers who only receive "eligible indirect compensation." In this case, only the provider's name and address or EIN must be disclosed. It is not uncommon for CSPs to receive only indirect compensation, such as revenue sharing and fees from investment funds that are reflected in the fund's NAV. However, "eligible" indirect compensation is limited to indirect compensation for which the provider has furnished disclosures regarding:

- the existence of the indirect compensation;
- the services provided (or reason) for the indirect compensation;
- the amount (or estimate) of the compensation (or a description of the formula applied); and
- the identity of the parties paying and receiving the indirect compensation.[10]

Part II of Schedule C requires disclosure of the name and EIN or address of a fiduciary or service provider that fails to furnish the information needed for Part I, including both the direct and indirect compensation information that must be specifically reported and the information with respect to eligible indirect compensation.[11] The type of services performed and missing information must also be described.[12] Accordingly, a CSP that fails to provide complete 408(b)(2) disclosures or at least specific eligible indirect compensation disclosures (even after they are requested in writing) will likely need to be reported as noncompliant in Part II of Schedule C.

The Preparer Problem

The problem for recordkeepers and TPAs with respect to the Schedule C information is nearly identical to the prohibited transaction issue. That is, the preparer will not be in a position to know whether simplified reporting of eligible indirect compensation is available and will not know whether it must complete Part II of the Schedule C for a non-compliant

[8] See Instructions for Form 5500, "Line-by-Line Instructions for Schedule C," at p. 21-27.
[9] Id.
[10] Id. at 26.
[11] Id.
[12] Id.

service provider unless it is able to confirm that the advance disclosures were made.

AUDITOR ISSUES

When a large retirement plan's accountant performs the plan's annual financial audit, one of its functions is to identify and report prohibited transactions (including in its opinion that is included in the Form 5500 filing). In relevant part, ERISA Section 103(a)(3) requires that the accountant shall:

… conduct such an examination of any financial statements of the plan, and of other books and records of the plan … to form an opinion as to whether the financial statements and schedules … are presented fairly in conformity with generally accepted accounting principles … Such examination shall be conducted in accordance with generally accepted auditing standards, and shall involve such tests of the books and records of the plan as are considered necessary by the independent qualified public accountant.

Section 103(a)(3) also requires the accountant to:

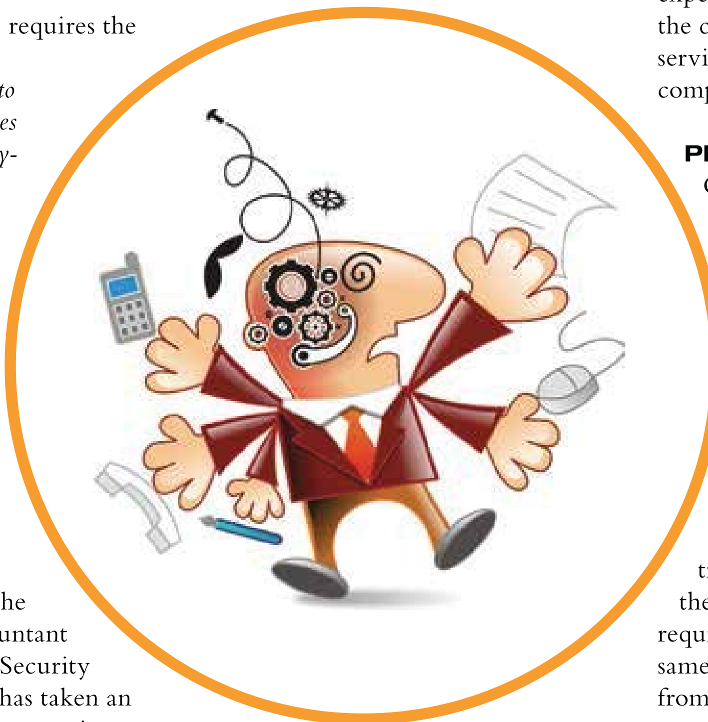
… offer his opinion as to whether the separate schedules (including a schedule of party-in-interest transactions) … and (the plan's Summary Annual Report) present fairly, and in all material respects the information contained therein when considered in conjunction with the financial statements taken as a whole.

The issue of accountant responsibility is not merely technical.

The DOL, through the Office of the Chief Accountant of the Employee Benefit Security Administration (EBSA), has taken an active enforcement role in ensuring the quality of large plan audits. The EBSA's initiatives in this regard include on-site work paper reviews of auditors with significant benefit plan practices and limited reviews for those who audit only a small number of plans with respect to certain areas, including prohibited transactions.[13]

The EBSA has noted that one of the most common areas of audit deficiency is with respect to prohibited transactions, that there is often no work performed or the work is inadequate (such as the auditor deeming the prohibited transaction issue to be "not applicable").[14] If audit work is deemed deficient, consequences imposed by EBSA may include:

- an expanded review of the auditor's services to ERISA plans;
- rejection of Form 5500 filings; and
- referral of deficient audit work to the American Institute of Certified Public Accountants' Professional Ethics Division or applicable state regulatory authorities.



The Auditor Problem

To provide an unqualified opinion on a large plan's financial statements, accountants will want to confirm that the plan sponsor has engaged in a reasonable process to determine whether it has received all of the required disclosures and whether it has a "reasonable belief" that they were complete.

While it may not be reasonable to assume that CPAs will uncover any and all prohibited transactions in which a plan or its parties in interest may have engaged, it is reasonable to expect them to determine whether a plan sponsor has taken reasonable steps to determine whether a prohibited transaction related to the 408(b)(2) disclosure requirements has occurred. On the other hand, the accountants would not be expected to opine on such matters as the commercial reasonableness of a service arrangement or the provider's compensation.

PREPARER PROCEDURES

One answer to these problems is for the preparer to request the information needed to complete the Form 5500. Following are some suggested steps. This is not intended to be an exclusive list, but rather, suggestions for ways that preparers can help their clients in complying with both the 408(b)(2) requirements (to avoid committing a prohibited transaction themselves) and the reporting and disclosure requirements of ERISA, while at the same time protecting the preparer from exposure to liability for failing to carry out its duties adequately.

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[13] For a general description of these initiatives, see Ian Dingwall, EBSA Update – Chief Accountant, "EBSA's Audit Inspection Program," p. 13-16, at http://macpamedia.org/media/downloads/2010EBP/DOL_Update_outline.pdf.

[14] Id. at 16.

- First, it may be helpful to provide the client with a short "primer" on the 408(b)(2) requirements. This could include an explanation of the "reasonable belief" requirement and related review steps; what types of providers are CSPs; and what information the disclosures should contain.
- Second, ask who the covered service providers are to the plan. One way this can be accomplished is by providing the client with a simple checklist indicating the types of services that are most likely being provided and asking the client to verify whether they receive them and, if so, identify the provider and find out when they entered into the relationship with the provider.
- Next, ask whether and when the disclosures were delivered. If they were not, this means there was likely a prohibited transaction by the CSP … and could be a prohibited transaction involving the plan fiduciaries.
- If disclosures were provided, ask if the client has compared the disclosures received against the requirements of the regulation. We recommend that plan sponsors utilize a "checklist" approach to reviewing the disclosures, in order to formulate the required "reasonable belief" that they are complete. (In fact, our plan sponsor clients have found the checklist approach to be very helpful.) The preparer will want to determine if this process was undertaken by the plan sponsor and, if so, whether the plan sponsor confirmed that the disclosures were adequate.
- The complete checklist and responses to the questionnaire are information on which the preparer can rely. By requiring the plan sponsor to make affirmative statements regarding the CSP's satisfaction of the 408(b)(2) disclosure requirements, the preparer can protect itself from problems that could arise if the answers on the Form 5500 are not correct.

We should clarify that it is the ERISA administrator's (*i.e.,* plan sponsor's) duty under ERISA to complete the Form 5500. However, in light of the increased number and transparency of potential prohibited transactions that result from the 408(b)(2) disclosure requirement, the consequences described in this article justify the record keeper or TPA in taking on a more proactive compliance role.

> "The preparer needs to have a process for verifying whether and how well the required disclosures have been made."

We have interviewed several accounting firms that focus on auditing retirement plans. They indicated that they will be requesting information from plan sponsors about their procedures for confirming that all CSPs have furnished 408(b)(2) disclosures and reviewing the disclosures for completeness. If a plan sponsor does not have reasonable procedures in place, the accountant will need to require that they be implemented or it will not be able to issue an unqualified opinion.

If there is an absence of reasonable procedures to ensure 408(b)(2) compliance, the accountant may need to work with ERISA counsel to determine if, in fact, any reportable prohibited transactions occurred.

CONCLUSION

We expect the DOL to begin investigating plans for 408(b)(2) compliance in mid-2014 (based on the 2012 Forms 5500 which will be filed later this year). We have already represented plan sponsors and service providers in DOL investigations where the 408(b)(2) disclosures were required to be provided as a part of the investigation—even though the investigations involved plan years prior to 2012. In light of the likelihood of some 408(b)(2) disclosure failures, and the resulting prohibited transactions, record keepers, TPAs and auditors who prepare or audit Forms 5500 should consider taking on a more proactive role in protecting their plan sponsor clients—and in mitigating their own risk for incorrectly preparing or auditing Forms 5500. **PC**

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