REGULATIONS

The Wide Ranging Impact of 408(b)(2)

The 408(b)(2) rules have ushered in a new era. Plan sponsors, who now must know what services they receive and review the costs of those services for reasonableness, need help from their retirement plan service providers to understand disclosure and the responsibility it entails.

BY JOHN J. BLOSSOM, JR.

July 1, 2012, was a big day in the retirement plan world. Covered Service Providers (CSPs) were breathing a sigh of relief because they got their disclosures into the hands of their customers and clients. It seemed, for a moment, that the fog had lifted and there was time to relax and reflect on a job well done. But the real work was only beginning.

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The roots of plan sponsor responsibility as defined in ERISA Section 408(b)(2) are not new. Plan sponsors are mandated broad fiduciary responsibility for plan operation under Section 404 of ERISA. This fiduciary standard has existed from the very beginning of ERISA's regulation of qualified plans. The five fiduciary standards for an ERISA plan sponsor (or any qualified plan fiduciary) are:

- **Duty of Loyalty:** A fiduciary must discharge his duties solely in the interest of plan participants and beneficiaries.
- **Exclusive Purpose Rule:** A fiduciary must perform his duties for the exclusive purpose of providing benefits or defraying reasonable expenses of the plan.
- **Duty of Care:** A fiduciary must discharge his duties with the "care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." We know this duty as the "prudent expert" standard.
- **Duty to Diversify:** A fiduciary must diversify plan investments to minimize the risk of large losses.
- **Duty of Obedience:** A fiduciary must discharge his duties in accordance with plan documents and other plan instruments so long as they are consistent with ERISA.

The responsibility to determine that plan expenses are reasonable is rooted in the Exclusive Purpose Rule for the plan sponsor as a fiduciary. However, having or finding the information to fulfill this responsibility was a real challenge for most plan sponsors.

With a few notable exceptions, fee disclosure and transparent information about services to be received, costs that would be paid, indirect compensation paid by plan providers, sales compensation, etc., were difficult to determine from the information plan sponsors received. Many plan sponsors actually believed their plan was "free." At least, the plan sponsor was not aware of costs built into the plan, particularly with bundled providers.

The political and practical needs for improved and specific assistance to plan sponsors and plan participants for fee information resulted in action from the Department of Labor's Employee Benefits Security Administration (EBSA). Proposed regulations published in December 2007 gave rise to an interim final rule published on July 16, 2010 (with a July 16, 2011, proposed effective date) and (finally) a final rule, published on Jan. 25, 2012, with an effective date of July 1, 2012.

As part of its 408(b)(2) regulation, the DOL, in the rule's "Summary of Impacts" section, states: "… this final rule will provide substantial benefits by reducing search time and costs for fiduciaries to identify the relevant fee and compensation information they need to fulfill their fiduciary responsibility under ERISA." The DOL also predicted a three-year cost of compliance burden of 1,644,000 hours at a cost of $134,733,000.

Only time will tell whether the DOL's cost estimates and expected benefits are realistic, but the DOL states in its "Overview of Final Regulation" section: "… although the benefits are hard to quantify, the Department is confident they more than justify the cost."

SO WHERE ARE WE NOW?

Plan sponsors have a new responsibility and more pressure on an old one. All plan sponsors are responsible for 408(b)(2) compliance as part of their fiduciary responsibility to participants and beneficiaries. A "covered plan" is any plan within the meaning of ERISA Section 3(2)(A) with the exception of a simplified employee pension, a simple retirement account, individual retirement accounts, frozen 403(b) plans and contracts, HSAs and any plan with no "common law" employee participants.

Each CSP must provide the required disclosure of services provided and fees charged to plan sponsors, not to the DOL. New plans are required to receive 408(b)(2) disclosure prior to (defined as "reasonably in advance") entering into a service agreement with a provider.

Any payment from a plan that does not comply with 408(b)(2) will, by definition, be a prohibited transaction. If a prohibited payment is made to a service provider, it can trigger an excise tax, refunds of any payments made plus interest and potential imposition of a 20% penalty. It is the plan sponsor's duty to confirm receipt of required disclosure from each CSP.

A plan sponsor that does not fulfill its 408(b)(2) responsibility will commit a fiduciary breach, leaving it vulnerable to real or perceived losses by participants resulting from potentially unreasonably high costs paid from the retirement plan.

Many plan sponsors lack the time, expertise or commitment to collect and analyze 408(b)(2) disclosures even though they are required to do so. However, 408(b)(2) compliance is no less important than annual testing requirements, filing a Form 5500 or required participant notices. It is increasingly obvious that many plan sponsors will need the help of experienced professionals to assemble and analyze fee disclosures from each plan's CSPs.

Many ASPPA professionals are knowledgeable experts and serve the needs of the plan sponsor as part of their value proposition. Many plan sponsors will expect to rely on the services of the TPA, independent record keeper or financial adviser whom they trust to assure that all CSPs have been identified and all 408(b)(2) disclosures have been received. In many cases it will be a pension professional who will be the catalyst that results in compliance.

It can also be expected that a plan sponsor which finds itself in trouble with a disappointed plan participant or the DOL will look for someone to blame for the trouble. Careful documentation of what you expect to do — and what you will not do — for the plan sponsor becomes more important than ever.

Questions about 408(b)(2) compliance services should become a standard part of the process of selecting business partners to work with when providing plan services. A TPA that partners with a bundled provider or an independent record keeper without reviewing their 408(b)(2) business process and a sample disclosure is courting disaster. There are providers who do an outstanding job of disclosure — and there are a few who don't even accept responsibility as CSPs.

Anyone with whom an ASPPA professional works in qualified plan sales and service should be ready to explain their 408(b)(2) disclosure and demonstrate it. Without disclosure, anything that generates a plan level fee is prohibited. This includes direct payments that come from plan assets and indirect compensation (payments that can expect to total more than $1,000 during the life of the contract for services that are paid by a CSP — production bonuses, TPA subsidies, revenue sharing, etc.).

ENFORCEMENT AND COMPLIANCE

The competitive retirement plan sales industry may be the best enforcer of the 408(b)(2) regulations, and the greatest beneficiary, particularly in micro and small plan markets.

New sales processes are being driven by offers to assist with 408(b)(2) compliance. Assistance with the determination of whether all covered service providers have delivered satisfactory disclosure can be a big help to many plan sponsors. If incumbent service entities are lax in supporting their client needs to assemble and understand disclosures, the plan sponsor may be open to discussing these matters with a competitor.

It's clear that plan sponsors have a responsibility to review the reasonableness of costs paid by plan participants. In the preamble of its proposed interim regulations for 408(b)(2), the DOL makes the following comments:

- "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 plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan."
- "Small plan fiduciaries are likely to benefit most — lacking economies of scale and negotiating power, they would otherwise face the greatest potential cost to obtain and consider the information necessary to the performance of their duty."

DOL confirmation of the necessity for review and determination of reasonableness has fueled growth of providers who provide benchmarking of service fees. Since a plan sponsor is required to monitor and measure the efficacy of services and fees, services that offer solutions for this need are flourishing.

BENCHMARKING

Benchmarking services of many varieties are proliferating in response to the fiduciary imperative that plan sponsors review their 408(b)(2) disclosures and make judgments about the reasonableness of plan costs. Some advisors routinely offer benchmarking services as a method to measure costs. Advisors may offer benchmarking to prospects as a way to discredit and displace an incumbent provider.

A retirement plan professional should ask a number of questions in determining an appropriate

Full Disclosure - Cost Analysis Sample

Asset Class	Asset Allocation		Fund Name	Expense Ratio		P.E.R.	
Large Growth	$357,500	11%	T. Rowe Price New America Growth Adv	1.07%	$3,825	0.38%	$1,359
Large Blend	$0	0%	Schwab S&P 500 Index	0.09%	$0	0.02%	$0
Large Value	$455,000	14%	American Funds American Mutual R4	0.67%	$3,049	0.33%	$1,502
Mid-Cap Growth	$65,000	2%	Columbia Acorn Z	0.77%	$501	0.38%	$247
Mid-Cap Value	$130,000	4%	Ridgeworth Mid-Cap Value Equity I	1.07%	$1,391	0.38%	$494
Small Growth	$65,000	2%	Janus Triton T	0.94%	$611	0.33%	$215
Small Value	$97,500	3%	Victory Small Company Opportunity A	1.41%	$1,375	0.38%	$371
Real Estate	$130,000	4%	Cohen & Steers Realty Shares	1.03%	$1,339	0.38%	$494
Commodities Broad Basket	$130,000	4%	Pimco Commodity Real Return Strat Cl A	1.19%	$1,547	0.38%	$494
Foreign Large Blend	$455,000	14%	American Funds Europacific Gr R4	0.85%	$3,868	0.33%	$1,502
Diversified Emerging Mkts	$65,000	2%	Goldman Sachs Struct Emerg Mkt	1.58%	$1,027	0.48%	$312
High Yield Bond	$65,000	2%	Metropolitan West High Yield Bond M	0.80%	$520	0.38%	$247
Intermediate-Term Bond	$162,500	5%	Pimco Total Return D	0.75%	$1,219	0.38%	$618
World Bond	$162,500	5%	Templeton Global Bond Fund Cl A	0.89%	$1,446	0.38%	$618
Inflation-Protected Bond	$260,000	8%	Blackrock Inflation Protected Bond Inv A	0.86%	$2,236	0.38%	$988
Stable Value	$650,000	20%	Metlife Stable Value Fund II	0.35%	$2,275	0.35%	$2,275
TOTALS	**$3,250,000**			**0.81%**	**$26,228**	**0.36%**	**$11,733**

	Weighted Average Expense Ratio	0.81%	$26,228
	Plan Expense Reimbursement Offset	-0.36%	-$11,733
	EXPENSES SUB TOTAL	**0.45%**	**$14,495**
Administration /Recordkeeping	*Recordkeeping & TPA Services Annual Flat Base*	0.08%	$2,500
	Per Capita Recordkeeping & TPA Services- $25 x 65 participants	0.05%	$1,625
	Recordkeeping & TPA Services Services Asset Based	0.10%	$3,250
Investment Advisory	*Investment Advisory Service –*	0.30%	$9,750
Trustee/Custodial	*Custodial Annual Base*	0.02%	$500
	Custody & Trading Asset Based	0.05%	$1,625
	TOTAL EXPENSES	**1.05%**	**$33,745**

Based on ABG-IL Moderate Asset Allocation Portfolio and fund information from Schwab Bank.

benchmarking solution. Here are a few:

What is to be benchmarked?

- Money manager cost?
- Total advisor fees?
- Total record keeper cost?
- All in total cost?
- Cost in basis points?
- Cost per participant?
- Participant behavior?

What is the appropriate benchmark for comparison?

- Asset size?
- Number of participants?
- Industry?
- Plan complexity?
- Arithmetic average of samples? (statistical mean)
- Middle of samples? (statistical median)
- Most frequent sample? (statistical mode)

Many benchmarking offerings compare plan data against the statistical mean. It can be argued that the arithmetic mean is not an appropriate measure. Whether it is appropriate or not depends largely on a review of the data. Is the goal to benchmark against the average of plan data found in a database? Is the goal to benchmark against middle of the range of plans sampled, or should each factor be benchmarked against the most frequently experienced data for each criterion?

The key to appropriate benchmarking is complete information and full transparency. Some providers talk about the average expense ratio of the complete menu of funds they offer a plan. Average weighted cost based on the actual, or an assumed, allocation of fund choices made by participants is a more valid measure because it takes into consideration the fact that participants will not invest equally across all funds.

The table shows a sample cost analysis my firm prepares for clients. It is readily benchmarked against a variety of criteria. Whether it will be benchmarked or not, the cost analysis is complete and factual.

Disclosure, transparency and comparison against alternatives has become the norm for the retirement plan industry. A best practices business model includes taking steps that empower the plan sponsor to fully understand their plan services and costs. Of course, that same information will empower a competitor to see if an incumbent

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provider's costs are unreasonable. This is the private sector at work in reducing retirement plan cost. However, the basic rule is, "If you don't benchmark your services, a competitor will."

VENDOR SEARCH

The ultimate benchmarking tool is a set of alternative proposals based on the goals of the plan sponsor, specifics of the plan and of participant demographics. "Vendor search" has become a baseline service of advisors in search of new business. Analysis of competitive proposals is a complex task but, when done well, demonstrates the reasonableness, or unreasonableness, of current fees beyond argument.

A Request For Proposal on existing client business is a growing nuisance to incumbent providers who have not done a thorough job of fee disclosure as a defensive measure. The RFP is always a costly process for providers. The process may result in replacement of an advisor, replacement of the provider or a reduction in plan costs by the incumbent provider.

The vendor search process usually begins when a plan sponsor has not been well educated about the services and fees charged by current providers. Retirement plan professionals can save a great deal of time and minimize the risk of loss of a client by doing a thorough job of client education concerning services and fees charged.

CONCLUSION

The 408(b)(2) rules have ushered in a new era of retirement plan service. There is no requirement that a plan must select the lowest cost provider for services, but there is no question that plan sponsors must know what services they receive and review the costs of those services for reasonableness. Plan sponsors need help from their retirement plan service providers to understand disclosure and the responsibility it generates. The retirement plan professional who is prepared for this new era is the ideal person to meet these client needs. PC

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